

Challenge



COVER BY HOWARD WINTERS

Challenge

THE MAGAZINE OF ECONOMIC AFFAIRS

NOVEMBER, 1960

CONTENTS • VOLUME 9 • NUMBER 2

ARTICLES

- South of the Mason-Dixon 4
New activity, new problems, new goals. By Lorin A. Thompson
- The Invisible Hand of Tax Exemption 8
An unknown side of resource allocation. By Norman B. Ture
- I Can Get It for You Retail 13
Discounts and price competition. By Frank Meissner
- What Money Can and Cannot Buy 16
Financing education. By Werner Z. Hirsch
- Fewer Strikes, Smaller Wage Hikes 18
Labor-management relations in the Sixties. By Oscar Ornati
- The Deluxe Economy Model 28
New twist in marketing. By Stanley C. Hollander
- At Sixes and Sevens 32
The U.S. and Europe's common markets. By William Diebold, Jr.
- When Is a Market a Market? 36
Realities in Search of a Theory—No 2. By Shaw Livermore
- Gold and the Dollar Crisis 40
A commentary on Robert Triffin's book. By Henry G. Aubrey

INTERVIEW

- Colston E. Warne 22
President, Consumers Union of the U.S.

DEPARTMENTS

- Editorial 2
- Letters to the Editor 3
- Challenge Notes 21
- Reading Report 44

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CHALLENGE, the Magazine of Economic Affairs; Vol IX, Number 2; copyright 1960 by Institute of Economic Affairs, New York University. Second-class postage paid at Indiantown, Fla. Frequency of publication: monthly October through July (10 issues a year). Publication office: Indiantown, Fla. Executive, editorial and subscription offices: 475 5th Avenue, New York 17, N. Y. Address all correspondence to CHALLENGE, 475 5th Avenue, New York 17, N. Y. Single copy: 30c. Subscription rates: 1 year, \$3.00; 2 years, \$5.00. CHALLENGE is issued and distributed by Institute of Economic Affairs as a nonprofit, education and information service. The views expressed herein are those of the authors and not necessarily those of New York University. Printed in U.S.A.

ON THE DOMESTIC FRONT

SHORTLY AFTER this editorial appears, the American people will go to the polls to elect the next President of the United States. As of this writing the polls still indicate a surprising margin of undecided votes. Therefore, neither I nor anyone else can advance an informed guess as to who will be the occupant in the White House through 1964.

We can be fairly certain, however, that whoever our next President is, his primary task on the domestic front will be to provide leadership in the resolution of economic policy. This is saying a great deal, and perhaps, because of its generality, not saying anything at all. But it seems to me that by the mid-1960s American society must reach a consensus on what the role of government in the economy should be. Failure to do so would be a waste of 30 years of experimenting.

The next President will have the advantage of chronology over his three predecessors. As boy and as man, both Mr. Nixon and Mr. Kennedy matured during the days of the New Deal, the Fair Deal and the Right Deal—days when pump priming, fiscal and monetary policy, debt management, economic stabilizers and the timing of such instruments became the main variables of national economic decision making.

To sponsor a workable, effective synthesis of this past experience is the job of the next President. A successful resolution of this task would eliminate a major dilemma of our times. For more than a generation the issue of government in the economy has cluttered the national scene with controversy, misunderstanding and indecision—all tolerable in a democratic society, but costly if tolerated too long. There are other domestic issues already on the horizon. It is time to dispense with this old one. We have had sufficient opportunity to consider its pros and cons.

The new President will be in an ideal position to articulate, in an act of summation, the conclusions that the majority of us have drawn from the lessons of the past.

During the 1930s we learned that there is an area of national responsibility in the general economy; that in times of economic stress action speaks louder than words; and, finally, that the raising of hopes for a better tomorrow—by enumerating goals we wish to attain—is at least as good a way to preserve a free society as handing out platitudes of vague dimension.

During the 1940s we regained self-confidence. We found that neither the Depression nor the New Deal

had destroyed the nation; that we could marshal fantastic resources to fight and win a costly war; that we could demobilize precipitously and still enjoy the fruits of a relatively free economy; and, finally, that we could afford to write into law the national determination to prevent a recurrence of mass unemployment.

During the 1950s we regained our sense of balance. We learned that government in the economy was, at best, only an act of participation, not a solo performance; that the whole point to spelling out the national purpose of a healthy economy was to realize the full potential of a private enterprise system; that expansion of the public sector depended wholly upon the degree of private tolerance of this goal; and, finally, that the function of government is to moderate and stimulate the economic performance, no more, and no less.

What else can be done by a new President who already enjoys such a substantial legacy? He can, for one thing, pull together these various strands from the past into a coherent, recognizable and almost predictable pattern of economic behavior. He can, in other words, articulate through policy a clear-cut definition of what the American system is—and what can be expected of it.

Two major tasks of specific economic leadership will confront the next President: to develop *automatic and flexible* tax and expenditure stabilizers; and to inspire a system of cooperation whereby contracyclical measures can be coordinated at all levels of government. The President who takes office in January, 1961 can proceed with these tasks only if he can assume that the experience of the previous 30 years has been synthesized into the normal procedures of his era.

... and the foreign front

In foreign affairs the main problem will not be a synthesis of past policies but decision on a major issue that has been left unresolved for 11 years. It is becoming increasingly apparent—from the impasse on disarmament, from the recurrent Berlin crises and from Khrushchev's inexplicably crude performance at the United Nations—that relations between the U.S.A. and the U.S.S.R., and between East and West, will not improve until something definite has been done about China.

The next President must weigh the advantages accruing to the United States from the continued isolation of mainland China against three sets of disadvantages: (1) the possibility that U.N. entry will be voted for China in spite of U.S. opposition; (2) a desperation secessionist move by the Communist bloc will destroy the U.N.; or (3) China outside the U.N. leaves either the U.S.S.R. or the U.S.A. to cope with the giant of the East unilaterally, a job which neither relishes.

The march of events is pushing the U.S.A. to make an irrevocable decision on China. The next President will not be helped much by the past. Only a new look at the problem can help him to decide.—H.B.

LETTERS TO THE EDITOR

Challenge invites your comments. Address letters to CHALLENGE, 475 Fifth Avenue, New York 17, N. Y.

LAG IN INNOVATION

• Prof. Hoselitz's optimistic faith that the proliferation of Research and Development (R&D) departments in industry will shorten the time lag between the discovery and application of inventions [October CHALLENGE] is premature.

The facts about R&D brought out by Prof. Hamberg in the July CHALLENGE do not support this judgment. Prof. Hamberg shows that R&D departments of big corporations initiate few important technical innovations. Specifically, he points out that "virtually all important recent advances in the methods of producing primary steel have come from outside the industry or from small firms within the industry."

Surely some of the blame for this situation rests on our methods of education. They have not been outstandingly successful in encouraging the type of thinking that produces important inventions. To a great extent we have used European scientific discoveries and inventions as the basis for our technical advances.

On the economic front, Prof. Hoselitz's belief that the lag between the formulation of new economic theories and their application is shortening also seems more cheerful than the facts warrant.

Increased interest in economics is not likely to decrease this lag, for much of our thinking about economics is shackled by dogmas. For instance, many influential persons still believe that there is a special sanctity about the law of supply and demand and that interference with it is wrong. In fact, this law is merely the economists' way of stating certain relationships between demand, supply and price.

We need to discard the belief that economics is concerned with right and wrong and realize that it is a method of analysis and forecasting. We will then be able to move much more quickly than we do now in using economic insights to solve practical problems.

WILLIAM MEDINA

Buffalo, N.Y.

CONCERN OVER LAG

• The lag, so well documented by Prof. Hoselitz, between insight into economic

problems and application of that knowledge is a vital problem. With the Communists breathing down our necks, we need to discard outworn ideas that handicap us.

ALBERT SCHNIEDER

New York, N.Y.

PROBLEM FOR UNIONS

• In the October CHALLENGE, Prof. Chamberlain speaks about the labor movement's ambitions to organize additional workers. Employment is growing most rapidly in the service industries, therefore labor organizers are trying to appeal to service workers. But these workers won't sign up with unions unless they are seriously dissatisfied with their wages. It follows that the unions can only get a striking increase in membership if there is a severe recession.

PETER O'BRIEN

Akron, Ohio

GOVERNMENT CONTROLS

• The Democratic case for large increases in spending for housing, education and health services was put very well by Prof. Harris in your October issue. But he failed to meet a vital point made by Dr. Wallich, his Republican opponent, in the debate on "What Is the Right Economic Policy?" Dr. Wallich pointed out that the Democratic program of increased government spending as well as a higher rate of economic growth would lead to government controls. This issue was ducked by Prof. Harris, who contended himself with saying that we could do without "any serious controls" at the present time. He supported this judgment with the unconvincing argument that the Democratic program would not be as expensive as some of its opponents claim.

S. H. MASNIK

Los Angeles, Calif.

ABSTRACT APPRECIATED

• Congratulations on the abstract in the October CHALLENGE. Prof. Turner has provided a valuable service by outlining the reasoning and recommendations of *The Staff Report on Employment,*

Growth and Price Levels prepared for the Joint Economic Committee of Congress.

A. W. DELANEY

Birmingham, Ala.

ABSTRACT ATTACKED

• The abstract of *The Staff Report on Employment, Growth and Price Levels* was long-winded and unintelligible. This reader got lost somewhere between "GNP deflation" and "the income velocity of money." If this is an abstract, please publish an abstract of the abstract.

RALPH TUCKER

Washington, D. C.

BLOC VOTING QUERIED

• Prof. Roy Peel makes constant references to the so-called Catholic vote or Jewish vote or Negro vote in his otherwise excellent article ["How People Vote—and Why," October, 1960]. While this type of bloc voting may have existed a generation ago, aren't the professional pollsters perpetuating a myth by insisting that it is still prevalent? When, say, Negroes in a certain district tend to vote for one particular party, it may not mean that they are voting this way because they are Negroes.

Election districts or precincts usually encompass neighborhoods whose residents are more than likely to be in similar financial circumstances. Voters in these areas cast their ballots on the basis of their economic interests as well as their racial or religious background. While it certainly can be argued that the average Negro voter is more concerned with civil rights than his white counterpart, he also votes as a veteran, a consumer, a taxpayer or a union member. The trend away from racial and religious bloc voting will be even more pronounced when we finally eradicate the remaining racial and religious barriers in America.

WALTER CANTWELL

Pawtucket, R.I.

EDUCATIONAL STANDARDS

• Why do both political parties make a fetish of local control of education? As Mr. Hechinger says in "Education Needs vs. Platform Promises" in your October issue, local control means that "people are educated only as well (or as badly) as a local school board desires." Surely improved education is such a pressing need that schools should be required to measure up to a minimum standard. If this cannot be achieved without giving up some local control of education, let's make the sacrifice.

EDITH KROLL

Baltimore, Md.

South of the Mason-Dixon

by LORIN A. THOMPSON

■ THE CIVIL WAR came as a devastating shock to the South and profoundly affected every aspect of life south of the Mason-Dixon line for decades. In fact, today, nearly a century later, the South is still adjusting to the new way of life which that war imposed on her society.

Many social and economic changes have taken place, especially in recent years; many changes will occur in the years to come. Though there are temporary obstructions, the main stream of growth continues.

In recent years, particularly since World War II, the changing South has been described as undergoing a "renaissance" because of the extent and the speed of the changes taking place. Certainly these changes have been profound.

The old agrarian values have been giving way to a new urban-centered society. The rigid social structure and the strict segregation policies have shown signs of crumbling. New economic strides have been taken which have raised the per capita income level of the people. In the process, educational facilities have been improved and the walls of sectionalism that have kept the South for so long in comparative isolation from the rest of the nation have been largely broken down.

What is the nature and the extent of this "renaissance"? This is the question to which this article is directed.

It is important to remember, first of all, that the South is not an economic entity; conditions in its various sections differ markedly. (In this article the South is defined to include those 12 states designated by the U.S. Department of Commerce as the Southeastern states. These are Alabama, Arkansas, Florida, Georgia, Kentucky, Louisiana, Mississippi, North and South Carolina, Ten-

nessee, Virginia and West Virginia.)

Traditionally, this entire area has been an agrarian region. This tradition extends back to the earliest settlement of the area, which took the form of large-scale plantation enterprises. Long before the Civil War, however, the plantation operations were becoming increasingly unprofitable; their productivity was not sufficient to support the large staff of slaves required to carry on the work.

But, though the economic pattern broke down, many of its social aspects have persisted to the present day. The rigid stratification of the social life of the South, racial segregation, the ideal of *noblesse oblige* as personified by the wealthy, independent landowner responsible for large numbers of agrarian workers—all these traditions are still very much a part of the Southern social scene. Thoughtful students of the South, such as Dr. William H. Nicholls, a Southern economist who teaches at Vanderbilt University, have argued that the persistence of agrarian values has been a major obstacle to the region's industrial expansion.

Inferior way of life?

Until quite recently, many Southerners regarded industrial and urban development as an inferior way of life. Consequently, through the years, more and more Southern communities faced the dilemma of having too many people trying to make a living off too little land, while too few jobs were available in the non-agricultural sector for the surplus manpower. As the problem became more and more acute, the old agrarian pattern finally began to break down and, in recent years, there has been a distinct trend toward urbanization in the South.

Census statistics show that during the past two decades rural population in the South has declined, while urban population has increased. By 1950 about 38 per cent of the population was classified as urban. (In the rest of the nation urban residents made up 72 per cent of the population.) Today, probably about half of the Southern population is urban—a significant increase since 1950—while in the rest of the nation the proportion of urban to nonurban population has remained fairly stable, with about 75 per cent of the population now living in cities.

This migration to the cities has had an effect on the racial structure of Southern society. While the non-white population has increased in the urban areas, it has declined in the rural farm areas. The white farm population, on the other hand, shows an increase. The white population is also gaining in the urban areas (although not so fast as the nonwhite population). Moreover, the migration of the Negroes from the South continues, while the expansion of industry and business has brought more whites to the South.

The greater mixture of whites and nonwhites in Southern cities has not yet involved a breakdown of segregated living patterns. While the Negroes are moving to the central cities, the white population has been moving to the suburbs, apparently motivated by a strong desire to minimize the mixing of races in residential neighborhoods and, consequently, in public schools.

It must be pointed out that this general population pattern varies greatly from state to state. As a whole, the population of the South has increased only 75 per cent as fast as that of the rest of the nation. But in a few states—Arkansas, Missis-

issippi and West Virginia—population has actually *declined* since 1950.

On the other hand, certain states—Florida, for example—have grown faster than the nation as a whole outside of the South. In general, the least populous states have the highest percentage of rural population.

"Outmigration"

While the migration from the country to the towns has relieved to a certain extent the problem in agriculture, industrialization has not proceeded rapidly enough in the cities to absorb the overflow. Consequently, there has been a considerable "outmigration" to areas beyond the greater South. Between 1930 and 1950, more than two million persons (72 per cent of them Negroes) left the South. This represents a considerable drain on the region's human resources and educational investments. Too many young people, whose education has been paid for by the South, are leaving the area before they have made any return contribution to the Southern economy. A recent University of Tennessee study estimated that this drain on the investment in youth through outmigration amounts to about \$135 million annually for Tennessee alone. Obviously, if the South is to make the best use of its resources, greater efforts should be made to provide opportunities for its youth.

To what extent are these opportunities being provided through industrial development within the South? To gauge the rate of the South's industrial expansion during the postwar years, we must look at the increase in the number of manufacturing establishments, the rate of new capital expenditures in manufacturing, and value added to products by manufacturing.

The average annual rate of increase in new manufacturing establishments in the entire U.S. between 1947 and 1954 was 2.7 per cent. Significantly, the rate of increase for the Southeast was 3.6 per cent, and for the rest of the nation it was 2.5 per cent.

This pattern of growth in manufacturing continued between 1954 and 1958—with Southern manufacturing establishments increasing at a rate of 2.1 per cent and those outside the South at a rate of 0.95 per cent.

With respect to new capital invested in manufacturing plants, the average annual rates of increase between 1947 and 1954 were 5.8 per cent for the Southeast, and 4.1 per cent for the rest of the nation. During the next four years the figures were 4.1 and 3.7 per cent respectively.

Finally, the South has the edge over the rest of the nation in the average annual rate of increase in value added to its products through manufacturing. During the first



period of consideration (1947 to 1954) the figure for the nation outside of the South (8.2 per cent) was slightly higher than the figure for the South (8.0 per cent). But the figures for 1954 to 1958 were 8.7 per cent for the South and only 4.5 per cent for the rest of the nation.

These figures show an impressive growth in Southern manufacturing since the end of World War II. Though the South still has a long way to go before her total industrial production will equal the level of production in the rest of the country, many Southern communities have, nevertheless, achieved a fairly good balance of employment in manufacturing, trade and service industries. In these communities factory employment has quite naturally led to expansion of retail and service industries.

The rate at which individual Southern states have industrialized has varied widely. While Florida's share of the nation's manufacturing establishments has increased rapidly (with 3,500 new plants since 1947), Arkansas and Mississippi have succeeded only in maintaining the same proportion of the nation's manufacturing establishments as they had in 1947. As for new capital expenditures for manufacturing, the recent record (1954-58) ranges from West Virginia's increase in investment of 66 per cent to Kentucky's *decline* in investment of 11.7 per cent.

It is interesting to note that the general patterns of new capital investments through 1958 have no apparent relationship to the 1954 Supreme Court school decision. New capital invested in manufacturing plants has been based on economic, not social, conditions.

It is true, however, that those communities which have experienced violence as a result of the Supreme Court decision have definitely suffered a setback in their economic progress. Between 1950 and 1957, for example, Little Rock, Ark., gained 40 new industrial plants employing 2,378 people, and there was every evidence that this trend would continue. But since the school crisis of September, 1957, not a single new plant has been established in Little Rock.

What has been the impact of urbanization and industrialization on the living standards of the people of the South? The best indicator of the change in living standards is the per capita income level. Here, again, the South has shown a slow but steady improvement over the last three decades.

In 1930 the South's per capita income level was only 50 per cent of that of the nation as a whole. By 1940 that figure had risen to 58 per cent; by 1950 it had advanced to about 68 per cent. During the 1950s improvement was relatively slower. By 1958 the per capita income level of the South was still only about 71 per cent of the level of the nation as a whole.

Though this is an impressive record of improvement, the fact remains that growth in the South will need to proceed faster than that of the rest of the nation for a consid-

erable period before per capita income for the region approaches the national level. At present the South has about 15.7 per cent of the nation's personal income and about 21.7 per cent of its population.

Again, the figures on income vary greatly from state to state. The level of per capita income in Mississippi, for example, is still only about 52 per cent of the level of the nation; Florida's per capita income figure, on the other hand, is 91 per cent of the level of the nation.

Throughout the South, the historically dominant role played by agriculture in the employment picture has tended to keep income down. Because of overemployment in agriculture, the value of agricultural products per farm worker has been far less in the South than in the rest of the nation. But with the growth of industrialization in the South the level of income has, as we have seen, steadily risen in recent years.

Wage differentials

There are, of course, wage differentials among different kinds of industry as well as between the industrial sector and the agricultural sector of the economy. Wage and salary payments in the metalworking industries, for example, are well above those in the textile industry in all parts of the country. Since textiles make up a considerable portion of the South's manufactured products, income derived from employment in the manufacturing industries is less than it might be if the product-mix were different.

Between 1948 and 1954 only 22 per cent of the increase in manufacturing employment was in the South. Between 1954 and 1958, however, the South garnered 55 per cent of the increase. These figures, along with those previously quoted concerning the rate of capital investment in manufacturing, are the basis for the claims of rapid and spectacular economic development in the South. Certainly, the gains are impressive, and they undoubtedly account for a large part of the rise in the South's per capita income. But the fact remains that during this decade of manufacturing growth, wages in Southern manufacturing plants were only 76 per cent

of manufacturing wages in the nation as a whole.

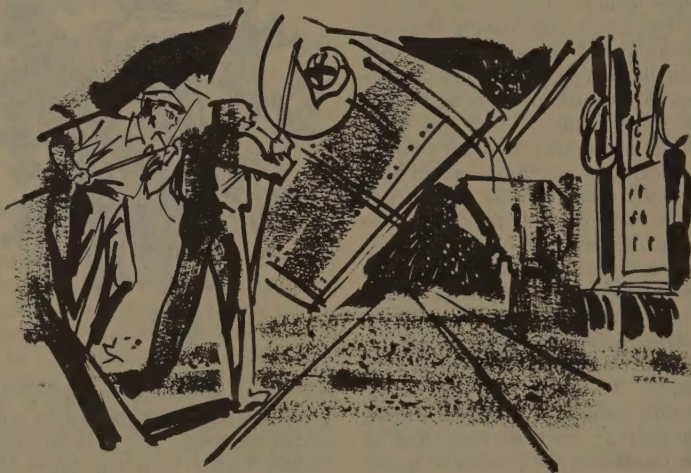
The greater opportunities for employment in industry, in addition to attracting farm workers, have also drawn a large number of Negroes who formerly worked as domestic servants. The Southern Negro has come to a new awareness of the possibilities of improving his social status. Where other types of employment are open to him, he prefers not to be considered a servant. The rapid rise in wages for domestic servants since 1940 and the increasing availability of labor-saving household appliances are other factors behind the decline in domestic service jobs.

The expansion of government activities has played an important part in raising the level of per capita income in the South. Of particular importance have been federal government expenditures in connection

in 1958 the figure stood at 20.4 per cent. It is interesting to note that the rise in personal income in the South has paralleled the increases in the share of government wages and salary payments. Apparently, government wages and salaries have exerted some influence on the level of earnings in other occupations.

Room for improvement

Proprietors' income has also increased substantially in the South over the last three decades. A look at the income of farm proprietors reflects the improvement in the farm situation as a whole. Between 1930 and the present the South's share of the nation's farm workers decreased from 50 to 40 per cent. Meanwhile the income of Southern farm proprietors throughout this period remained fairly steady at about 25 per cent of total farm proprietors' income in the nation. Obviously, though Southern farm proprietors



with national defense. Those states which have large military installations have benefited substantially. Another influence has been increased expenditures by state and local governments for expanded public services.

Influence on other areas

In 1930 only 13.1 per cent of the wages and salaries paid by government (federal, state and local) went to residents of the South. By 1940 the South's share of national income from government had gone up to 16.8 per cent; by 1950 it had increased further to 19.8 per cent; and

are better off today than they were 30 years ago, there is still much room for improvement.

The statistics also show growth in nonfarm proprietary business in the South. In 1930 the South had only 11.9 per cent of the total national income of nonfarm proprietors. Today about 16.4 per cent of national income from this source is realized in the South.

From this analysis, it is apparent that the South has attained an economic "renaissance"—if, by that term, we mean a significant growth in industrialization, employment

opportunities and per capita income. But, so far, this renaissance has not lifted the South to the standard of living enjoyed in the rest of the nation. Southern businessmen recognize this fact, and their efforts to attract new industry and new business undoubtedly will close the gap further in the years ahead. The South wants new industry and new growth even though it is sometimes reluctant to accept the accompanying adjustments in social attitudes and traditional ways of life.

The 1954 Supreme Court ruling which declared segregated schools to be unconstitutional has produced social tensions which have interrupted and deferred some plans for economic advancement. However, there is a growing awareness that violence, disorder, reprisals and recriminations will not build a solid social and economic structure. Increasingly, in many parts of the South the voice of moderation is being heard as more and more Southerners have come to realize that economic growth is incompatible with social disorder.

The Little Rock incident dramatically illustrates this point. As indicated earlier, industrial expansion in Little Rock came to a standstill after the violence that occurred over school integration. If a community would enhance its attractiveness to new industry, it obviously must resolve peaceably its internal disputes.

Bearing the lesson of Little Rock in mind, the citizens of Norfolk and Charlottesville in Virginia chose to close their schools rather than resort to violence when their schools were threatened with desegregation during the fall of 1958. In both cities

makeshift arrangements were made for continuing classes in homes, churches and other private buildings.

When the schools were reopened for the second semester under a token integration plan, attendance was comparatively low as a result of the expansion of private schools. The establishment of private schools was made possible under a Virginia law which allows the parents of students attending non-church-related private schools to apply for tuition grants up to a maximum of \$250 per year per student.

Private schools supported by tuition grants from public funds are new in American education. The first year of operation of this system in Virginia was quite successful. Many local people hailed this development as one providing "freedom of choice" in education. But it remains to be seen whether this arrangement will survive if attacked in the courts. Even if it does survive, there will be many difficulties.

Increasingly, people in Virginia, as well as in other parts of the South, are aware of this fact. The school crisis has brought about a new recognition of the relationship between public education and economic development.

Important industrial leaders in Virginia have pointed out this relationship. For example, Louis T. Rader, a top management official of the General Electric plant in Waynesboro, Virginia, has said:

"There is no doubt that the education climate and the business climate are interdependent. . . A good public school system is essential in attracting and holding trained en-

gineering and managerial talent."

Disappearing differentials

Despite difficulties and setbacks, within the last two decades the South has worked hard to improve its schools and the rate of school attendance. Public school education is more important in the South today than it has ever been.

In 1959 more than 15,000 classrooms were scheduled for completion in the Southeastern states. This was 22 per cent of the total number of classrooms scheduled for completion in the nation and is approximately equal to the South's share of the nation's school-age population. (In 1956 the Southeastern states had 26.4 per cent of the total public elementary school enrollment and 23.8 per cent of the public high school enrollment.) These figures indicate that differentials in educational opportunities between the South and the rest of the nation are gradually disappearing.

The old patterns of Southern politics are also changing. The rapidly growing urban and industrial areas of the South are pressing hard for better representation in the general assemblies. Interest in voting shows signs of increasing. Recent civil rights legislation should play an important part in increasing the number of Negro registrations. With the Negro becoming more and more interested in improving his status, there is reason to believe that he will not neglect his hard-won voting privileges.

Historically, participation in voting has been low in the South compared to the record in other parts of the country. In the Presidential elections from 1932 to 1948, only 41 to 47 per cent of North Carolina's voting-age population participated; in Virginia 20 to 23 per cent of voting-age population participated; and in South Carolina only 10 to 14 per cent of the adult population voted.

The democratic gubernatorial primaries usually bring out the largest number of voters, except for Presidential elections. Since in most Southern states nomination in the Democratic primary is tantamount to election, the number of votes in the primary usually exceeds the number in the general election for governor. Still, it is seldom that as

ECONOMICS AND SCHOOL INTEGRATION

Frank W. Cantrell, manager of the Arkansas Chamber of Commerce, has been frank to admit that Little Rock's troubles have seriously affected industrial development in the rest of the state, and the statistics on new plant investment in Arkansas substantiate him beyond any debate—\$131,100,000 in 1956; \$44,900,000 in 1957; and \$25,400,000 in 1958 . . . The increasing outspokenness [of Chamber of Commerce officials] in Arkansas is a good index of their growing feeling of desperation. And despite segregationist threats of boycott which have intimidated many businessmen, local business opinion has given their leaders substantial collective support. For example, in late February, 1959, the Little Rock Chamber of Commerce polled over 1,000 members, of whom 77 per cent favored reopening the public high schools even if it meant token racial integration. . .

William H. Nicholls, *Southern Tradition and Regional Progress*
Copyright 1960, University of North Carolina Press

many as 50 per cent of the qualified voters participate in such primaries.

However, the breaking of the "Solid South" in the last two Presidential elections may be an indication that this pattern, too, is changing. If the two-party system once again becomes a reality in the South, there will no doubt be a rejuvenation of political interest in all elections.

Many writers dealing with the South criticize the area for its nostalgia for bygone days. In doing so they tend to minimize the dynamic adjustments that are taking place as a result of the changes in agricultural practices, increased urbanization and industrial development. They also tend to minimize the vast adjustments in traditional patterns of thought that these developments require.

The technological revolution in American agriculture during the last 30 years has drastically changed the way of life throughout the South. The matter of desegregation in the schools in the South has produced a

good deal of social tension and has brought into focus the matter of federal, state and local responsibility with respect to education, civil rights and voting. Efforts of the Negroes to improve their social status through legal means and such forms of social pressure as the recent sit-ins at lunch counters has had a tremendous impact on Southern attitudes.

Many of the whites are, of course, resisting the breakdown of the historic pattern of segregation. They are also resisting federal encroachment on what they have always considered local matters — education, civil rights and voting. But certainly it must be realized that time is needed for a people to adjust their ideals and ways of life to economic and social changes.

Cultural interchange

During the past three decades the comparative isolation of the South from other parts of the nation has disappeared. New and modern highways, along with other forms of

transport, have been constructed. Electricity, telephones, radio and television have been extended to remote areas. These developments have provided the facilities for cultural interchange among regions of the nation. In addition, many of the South's manufacturing plants sell to nationwide markets. Regional dealerships and distributorships dispose of products coming from New England, the Midwest and the Pacific Coast.

As such activities continue, the differences between the South and other regions of the nation will become less sharp. Though the South, along with other sections of the nation, has strong feelings of regional pride and loyalty, this parochialism is changing as the result of trade and commerce.

Growth means change, and change can be painful. Societies, like men, often resist it. Nevertheless, while there will be temporary setbacks, there is every reason to believe that the Southern renaissance will continue. ■

An unknown side of resource allocation

the invisible hand of **TAX EXEMPTION**

by **NORMAN B. TURE**

■ FOR MOST OF US, there is nothing much the matter with the federal tax system except that there are too many taxes and the rates are too high. This judgment, very often, is a highly personal reaction, for the government's total tax take isn't regarded as too great; in a recent public opinion poll a large proportion of respondents opposed tax cuts at the present time. One's own taxes are what one complains about.

For many economists, however, there is less concern about the level of tax rates than about another aspect of the federal tax system. Most particularly, in the case of the income taxes, they are distressed by the lack of uniformity in the applica-

tion of tax burdens and the hidden effects thereof.

They note that the income taxes fall with widely varying severity on equal amounts of income, depending on the source of income or the manner in which it is spent. Many explicit and implicit provisions of the tax law provide differential treatment for various kinds of income and expense items. These differentials, it is claimed, have a significant impact on taxpayers' decisions in managing both their business and personal affairs. Tax considerations, in other words, may switch the signals of the market place.

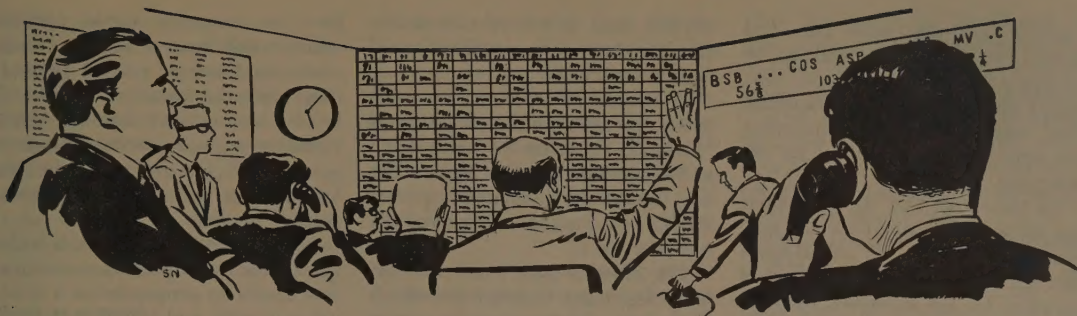
As an example of how this may happen, suppose you are considering

investing a certain sum of money. Your investment counselor suggests these alternatives: a municipal bond, or a common stock in a well-established, solid company which has paid a high dividend regularly for many years back.

Suppose the municipal bond pays 2.5 per cent per annum, and the seasoned common stock has a dividend rate of five per cent. In a tax-free environment, your choice would probably be the seasoned common stock, assuming you already have a properly diversified portfolio. As matters stand, however, your decision will be heavily influenced by the way the tax law treats the income from each of the two investments.

If you are in a high income tax bracket, you may find that the return on the municipal bond, *after tax*, substantially exceeds that of the seasoned stock. The reason is, of course, that interest on the debt instruments of states and localities is exempt from the federal income tax.

Your 2.5 per cent return on the municipal bond is the same before and after tax. But for a top-bracket individual, the five per cent return before tax on the seasoned stock



shrinks to less than one-half of one per cent after tax. In fact, for a top-bracket individual to get a two and one-half per cent return, after tax, out of taxable dividends, the before-tax rate of return on a stock would have to be almost 28 per cent. It is difficult to find a seasoned issue paying anything like this rate.

This illustrates the economists' complaint about the differential provisions of the tax law. These differentials alter the way in which resources, such as capital, are used. They do so by changing the relationship between before-tax returns and after-tax returns on alternative uses of resources. To put it in another way, resources would tend to seek the most profitable employment *before* taxes, if *before-tax* income guided the choice. But resources, in fact, seek the most profitable employment *after* taxes. Thus, the market puts a certain value on one allocation of resources; but the tax law may change this value.

The effect is to put pressure on people and firms to use their resources in ways which result in a total product lower than might otherwise be obtained. The real cost of tax differentials, therefore, is measured in terms of the misallocation of resources which the differentials encourage.

If these tax differentials result in a use of resources that is less than the best, why are they in the tax law? Many of these differentials have an intriguing history. In some cases, they were introduced to serve a public purpose which, at the time, appeared quite pressing, but which has long since lost its urgency. In other cases, a particular group of taxpayers appeared to deserve special relief. In

still others, no differentiation really was intended; the wording of the statute permitted some taxpayers to reap special advantages. In almost every case, one differential led to another. This is because those framing the tax law found it easier, and often deemed it more desirable, to correct the inequity of a given tax differential by extending it to more taxpayers rather than by abolishing it.

No easy cure

In recent years, there has been an increasing awareness of the extent of such differentials. Concern about their effects has led to mounting pressure for their elimination wherever possible. For many reasons, progress in this direction has been very limited. A major problem is that these tax differentials concern situations which are not always perfectly clear cut. It is difficult to determine just how far to go without creating a new inequity while eliminating an old one.

To cite one example, the Internal Revenue Code provides for the deduction of business expenses when these expenses are ordinary and necessary in the conduct of the taxpayer's trade or business. At first glance, this seems an eminently reasonable provision of a tax aimed at net income. With respect to business income, the base of the tax should be gross receipts minus the expenses incurred in producing them. If inadequate allowance were made for these expenses, the tax would fall in part on the capital of the business, instead of merely on its net income.

The problem arises, however, in determining what expenses are "ordinary and necessary." In effect, the law seems to be saying that expenses cannot be deducted (1) if they are

not conventional in the business, or (2) if they are extraordinary in amount compared with the usual business practice, or (3) if the business might still prosper without them. As a generalization, this statement of the purport of the law is in line with prevailing business ethics. Income tax returns, however, are not generalizations but detailed specifications of income and expense.

The statute runs into trouble, therefore, when applied to specific and often extremely complicated cases. Here the application of the law becomes a matter of subjective judgment by a revenue agent or by a court. Such judgments by different individuals are not likely to coincide very closely in the absence of a large volume of clear precedents.

Problems of this sort arise concerning virtually every type of business expense. Those which have received most public attention, however, have dealt with sales and other promotional expenses.

The tax treatment of expense accounts is about the most thorny problem in the income tax. The typical situation which causes so much furor involves a company's sales representative who spends lavishly in an effort to secure or retain a customer. Caribbean cruises, theater tickets, a season's box at sporting events, expensive gifts, are a few examples. For a company's executives, there may be country club memberships, use of the company's cars, hunting lodges, perhaps even a home—all at the company's expense.

Entertainment expenses which show up on the expense account often include those incurred on behalf of the employee's wife and the spouse of the prospective customer.

Exciting journeys with gun and camera through what used to be darkest Africa show up on the company's tax return as sales expenses. The cost of the boss' honeymoon has been known to appear in the same way.

To the extent that these expenses are allowed as deductions, the government—therefore, all of us—pays the bill for the goods and services provided for the employee, his sales prospects and others loaded into his expense account. Those on the re-

On this basis, it is hard to conceive of an expense which could not qualify as ordinary.

If "ordinary" won't do as a criterion for deductibility, what about "necessary"? Necessity might seem to be an easier test to apply. But how should one distinguish between the legitimacy of an expense and the necessity for it?

The African safari, for example, had a legitimate business purpose; it did indeed contribute to sales promotion, or so it was ruled. Was it neces-

how our economy could operate without this type of activity. Only under conditions of perfect competition, when the actions of individual buyers and sellers cannot alone influence price, is advertising a pure waste. But few industries in the United States sell in a perfectly competitive market.

As imperfect competition is widespread, the use of public communication media to propagandize a product or service, and to differentiate it from what would otherwise be a very close substitute, is a basic fact of life.

The income tax law, indeed, raises no question on this score. Advertising expenditures, as a general rule, are deductible as business expenses.

The problem centers on the content of the promotional effort. Quite substantial expenditures for getting across the message that Brand X is the best in its field occasion no concern. What about advertising which does not directly promote Brand X, but which leaves a warm spot for it in the heart of the public?

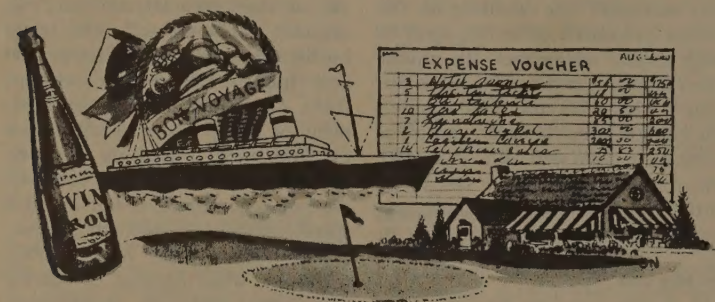
Spur to promotion

Listeners, readers or viewers can entertain such a feeling because the company sponsors a fine TV show, because its magazine advertisements are works of art, or because its newspaper advertising provides thoughtful and provocative discussions of important public issues. The tax law, its administrators and the courts certainly should not be required to define the types of advertising that are "ordinary and necessary."

Yet there is obvious abuse in this area. Should a manufacturing concern be allowed a deduction for editorializing in favor of one Near Eastern nation and against its neighbors? That the editorial is labeled "advertisement" and is "published as a public service" doesn't necessarily mean that it will increase sales or even that the company expects that it will.

Similarly, a sharply worded message, on a full page in a glossy magazine, about various kinds of labor practices may be regarded as a far cry from promotion of the sales of the message-giver. It seems evident that advertising of this sort is undertaken because its cost is relatively low.

A dollar paid out in advertising



ceiving end do not include the value of these goods and services in their taxable income.

The company, in other words, is allowed a deduction for a cost of producing income, but the recipients of these expenditures do not report them as income. This creates an anomaly. Though what is cost to one economic entity (in this case the company) *must* be income to some other (in this case the recipient), this is not always so from the point of view of the federal income tax.

Why not just disallow all such deductions? If this were done, clearly this type of sales promotion would cost the company considerably more. With the present corporation income tax rate of 52 per cent, every deductible dollar on an expense account costs the company only 48 cents. Remove the deduction and the cost shoots up—a dollar of expense is then a full dollar of cost.

Where should the line be drawn? The statute's "ordinary and necessary" rule for deductions is not much help in many cases. What is ordinary in one line of business is frequently extraordinary in another. In fact, the courts interpret "ordinary" to mean *not* unique in the business community—rather than customary in a particular business.

sary, however? Most of us would answer, unhesitatingly, that it wasn't. But what kind of objective criteria are we to use in deciding that the expense of this trip was not as necessary as an equal expenditure on some other activity which produced the same effect on sales?

Because of these difficulties in applying the vague language of the Internal Revenue Code, this kind of sales promotion effort meets with extremely liberal tax treatment. This situation encourages the allocation of a greater volume of resources to lavish sales promotion methods than would otherwise occur. Moreover, this result was not contemplated when the Internal Revenue Code was framed.

The frivolous—and well-publicized—activities for which tax deductions are claimed, offends Congressmen and Senators just as greatly as novelists and TV scenario writers. The apparent disinclination to amend the tax law in this area, however, does not imply approval of its results. It is, rather, evidence of the difficulties in making a change which will conform with legitimate business requirements.

Advertising and public relations activities, in general, present similar problems. It is difficult to conceive

really costs the company only 48 cents because the expenditure is deductible for tax purposes. As a result, there are advertising expenditures that would not be undertaken if there were no taxes. Resources—highly specialized and talented ones, at that—are channeled into promotional activity in greater volume than plain and simple business needs would warrant.

Taxes as subsidies

Since the end of World War II, deductions by U.S. corporations for advertising have grown very rapidly. In 1946 all active corporations claimed deductions for advertising totaling \$2.4 billion. In 1956 these deductions amounted to \$7.1 billion. It should, however, be noted that many other categories of business expense increased even more dramatically. Interestingly enough, advertising outlays were 8.7 per cent of all corporate deductions in 1946; in 1956 they were still at about 8.6 per cent of the total.

What can we conclude? The tax law has probably encouraged—or at least permitted—advertising to grow beyond the level it would have attained in a taxless economy.

This development is uneconomic in the sense that some of the resources committed to this industry could be more productively employed elsewhere were it not for the tax law. But the extent of this uneconomic development appears to be relatively moderate—particularly in light of the difficulties involved in rigorous delineation of legitimate deductions.

Various provisions in the tax law have effects similar to explicit government subsidies by the government. Both channel resources into fields which would otherwise not receive them. Few of us will deny that a subsidy is a legitimate instrument of public policy, although many of us are unhappy about the specific objectives of such subsidies. But if a subsidy may usefully achieve ends determined through the political—rather than the market—processes, why should the form of the subsidy be a matter of concern? Why aren't tax differentials just as good for this purpose as outright government payments?

Part of the answer has already been indicated. An important requirement of an effective subsidy is that its impact in shifting resources be determinable. Those who frame the law must have a good idea of the kind of resource movement they want and be confident that the subsidy can contribute to this movement.

When the effects of public action (such as tax provisions) on the allocation of resources are not fully known, the subsidy effect of the action will only rarely be welcome. Many tax differentials involve this surprise element. Their results surpass or significantly differ from those the framers of the law had in mind.

Just as important is the fact that subsidies conveyed by tax differentials tend to get out of hand, and very quickly. Explicit subsidies appear in the annual budget and are disbursed by a responsible agency; this involves a continuous check and evaluation of costs and results.

Differentials proliferate

Tax differentials, on the other hand, are not subject to frequent and periodic review; the Internal Revenue Code is not revamped each year. Moreover, it is difficult, if not impossible, to word a law so explicitly that only those originally intended to benefit from a tax differential can claim its advantages. The ingenuity of the American taxpayer in taking advantage, within the law, of the tortuous language of the Revenue Code is widely known.

Moreover, a group of taxpayers who just do not qualify for existing tax favors can at times get the scope of a differential broadened to include their case. Apparently, this is easier than getting an explicit subsidy widened to include companies and individuals whose principal activities were not deemed originally to warrant public support.

Tax differentials tend to proliferate mainly because the tax-writing committees of the Congress are made up of fair-minded men; they see the inequity in allowing favorable tax treatment to A while denying it to B whose situation is quite similar; and they fear the damage that may be done if the inequity is eliminated by taking the tax favor away from A.

They are hardly to be blamed if they don't notice C waiting in the corridor to find out how B fared before submitting a similar petition.

Most members of the Congress recognize this hazard. Why, then, does the tax law continue to be a vehicle for effecting shifts in the allocation of resources?

The major reason is that this form of subsidy presumably minimizes direct control by the government over those engaging in the subsidized activity. Most explicit subsidies involve some control by the subsidizing agency over the manner in which the subsidized activity is to be carried out. Sometimes, however, freedom from such control is a major criterion by which the effectiveness of public action is to be measured. In such cases, presumably, the objectives of public policy can better be served by tax differentials.

Tax-free activities

The best example is the very extensive support the federal government affords religious, charitable, educational, scientific and other non-profit organizations through various provisions of the income tax law. These provisions stem from the convictions: (1) that the activities of such organizations are clearly in the public interest; (2) that they are better undertaken under nongovernment auspices; and (3) that, subject to certain basic rules, they should be as free as possible of government supervision or control. To this end, these organizations are exempt from income taxes, and companies and individuals may deduct contributions to them.

On the whole, the nation has been well served by these provisions of the income tax law. For example, they have substantially increased the flow of funds to research and educational services at the advanced level. These activities provide much of the foundation for our material progress and greatly help to increase our productive capacity. Without tax support, the price of these activities would have to be significantly higher to cover the costs of the highly specialized resources they demand.

What would happen to the educational standards of people with middle and low incomes if advanced

education did not benefit from the present tax subventions? Educational standards for the entire nation would fall, since our elementary and secondary school systems would quickly feel the impact of pricing would-be teachers out of the necessary training. By the same token, considerable research would be lost if public support for it were withdrawn.

Nonprofit organizations

Most of us have a warm spot in our hearts for nonprofit organizations. Among them we see our churches, our colleges and universities, our hospitals, research institutions, libraries, museums, as well as the foundations which channel funds to these organizations. Every once in a while, however, what we see troubles us a bit. A nonprofit, tax-exempt research organization does precisely the same kind of work as a taxable research enterprise; or a university or church engages in activities which cannot be distinguished from those of an ordinary taxable business.

We can rationalize the former by arguing that tax exemption should extend to nonprofit organizations even if they are not the only ones doing the work. We can curb—and have done so—much of the abuse in the latter by emending the law to separate the business activities from the tax-exempt activities of the organization.

But many cases remain to cause us concern. A dog lover may assert that tax privileges for sanctuaries for stray cats do not serve the public interest. Scientists may complain that funds, talents and other research facilities are wasted by tax-exempt foundations concerned with metaphysical problems which lie just this side of necromancy. They may also be concerned about the seemingly useless competition for resources and the excessive duplication of efforts resulting from the tax-induced proliferation of research organizations.

Church leaders may well be justifiably alarmed about public support for faddist religious movements. This support comes from the deductibility of contributions to exotic religious organizations and the tax exemption

of the large investment income of some of these organizations.

There is little doubt that in some cases the present tax laws permit nonprofit organizations to use resources for purposes most of us would disapprove of, if given an opportunity to express our views. Moreover, public support of these purposes was not contemplated when the present tax provisions were framed. Many of the activities supported by these provisions would never see the light of day if those financing them had to put up their own money.

When an individual with an income in the top tax bracket makes a donation to a tax-exempt organization, he bears only nine cents out of every dollar of the cost. The remaining 91 cents of each dollar of the donation actually comes from the government—in other words, from all of us.

Control is difficult

In effect, we give the well-to-do donor the right to give away our money as he sees fit. While in most cases we approve, we have no recourse in those cases in which he uses our resources unwisely. Similarly, the tax-exempt organization enjoys the considerable advantage of not having to share its income with the government through income tax payments.

Should we prevent occasional abuses by eliminating the deductibility of contributions and the tax-exemption privilege? Control of this kind of situation in the public interest is extremely difficult. In some cases the abuse is so flagrant that the machinery of the law can handle it. But frequently determining the tax status of an organization applying for (or now enjoying) exemption, or determining the deductibility of contributions to such an organization, involves subjective judgment. What kind of firm guidelines can be provided?

This is not to suggest that we should encourage laxity in enforcement of the law. Rather we may have to accept, as an unfortunate but inevitable cost of the benefits the law provides, the occasional misdirection of valuable resources into frivolous or nonproductive activity.

This resource-shifting impact of the federal income tax is not confined, of course, to the few areas we have discussed. Indeed, tax differentials bring tax considerations into virtually every aspect of our business life and our personal finances. In every case these considerations tend to impel us to uses of the means at our disposal different from those we would undertake in a neutral tax environment.

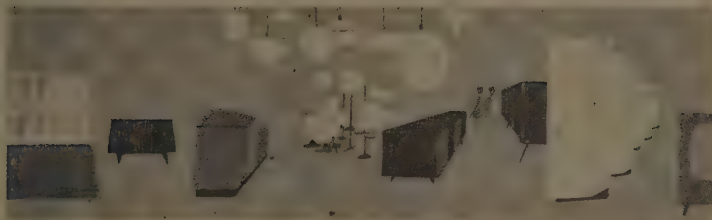
Eliminating these tax differentials, therefore, has assumed increasing importance among a number of economists. These economists are concerned with the effectiveness with which the nation's resources are organized in productive effort.

Broadened base

There are also other arguments for broadening the base of our individual and corporation income taxes—widening it by eliminating provisions that make the tax burden different, depending on the source of income or how it is spent. These arguments for change are: considerations of equity among similarly situated taxpayers; ease of enforcement and compliance; and the potential revenue that our tax system can produce. In addition, it becomes clearer each year that only by broadening tax bases will we be able to reduce income tax rates.

This approach to tax reform, however, is beset with difficulties. In many cases, eliminating differential tax provisions would be a drastic break with present policy. In others, it appears to be impossible to set up an objective criterion for drawing the line between the intended and the unintended results of taxes. In still others, no compelling public objective is served by present tax advantages, but their withdrawal may be blocked. This may occur because their elimination would require similar action in other instances where tax favors are held to be in the public interest.

Notwithstanding these difficulties, a start should be made. The objectives of a more nearly neutral income tax and the consequent improvement in the use of our resources are surely compelling enough to warrant facing up to the hard realities of constructive tax reform. ■



I Can Get It for You Retail

by FRANK MEISSNER

"The traders or producers who find that a rival is offering goods at a lower price than will yield them a good profit are angered at his intrusion, and complain of being wronged; even though it may be true that those who buy cheaper goods are in greater need themselves, and that the energy and resourcefulness of their rival is a social gain."—ALFRED MARSHALL, *Principles of Economics*, New York: Macmillan, 1948, p. 8. The first edition of this classic was published in 1890.

■ WE AMERICANS pay high prices for goods we buy at the retail level. Our inability to reduce marketing costs is an important factor in keeping prices up. While efficiency in manufacturing has steadily increased, efficiency in distribution has lagged. True, there have been gains in productivity in the physical process of distribution. But the provision of costly new services to customers has offset these advances. Customers have used, and paid for, credit, convenience, attractive surroundings, delivery, maintenance and repair.

How can the costs of marketing be reduced? At times, a ray of hope appears on the horizon. In the early 1920s, the supermarket reduced the cost of selling food. Now the discount house is doing the same in other fields. It is lowering prices of consumer durables such as TV sets and washing machines, and of non-foods such as clothing.

"I can get it for you at a discount" has replaced the old cry of "I can get it for you wholesale." Full-fledged discount houses are, in fact,

specialists in off-list pricing. They are streamlined operations based on presold national brands. The men who run them get up earlier than their competitors, and work later. Operators of discount houses find new ways to procure merchandise at low cost, and then pass the savings on to the customer.

Discounting, in short, is based on the existence of a well-established and well-recognized list price charged by "legitimate" dealers. The conventional trade provides a point of departure for the merchants who cut prices. Most old-line retailers occasionally sell at off-list prices. The discount house *always* sells, or at least says that it sells, at off-list prices.

Shattering influence

After World War II, discount houses spread with breathtaking speed in the United States. Their influence on conventional retailing was shattering.

Classical economics teaches that in a freely competitive economic system an institution will gain a foothold if it fulfills a need. Let us examine some of the factors that favored the growth of discount houses.

- From 1940 to 1948 there was a sellers' market. Price competition hardly existed. The rigors of such competition, therefore, came as a shock to retail management unaccustomed to this way of doing business.

- With threats of fair trade laws, legislators and courts have sought to bottle up price competition. The discount house is a protest against this.

- Production has caught up with demand. During the war and the years immediately following, most manufacturers could sell all they could make. This situation has been reversed. Many producers are, for the first time in years, faced with a serious problem in disposing of their output. They have been forced to work through retail merchants who during the lush years forgot how to sell and were not especially anxious to relearn their lost skill.

Many manufacturers, as a result, found that to market an output comfortably above their break-even point, they had to use the new and unconventional discount houses. Whatever undesirable features they may have, discount houses have the compelling virtue of moving goods into the hands of consumers.

- Though personal income rose faster than prices, consumers became increasingly irritated by constant price advances. The discount house offers to ease this irritation.

- Greater leisure made possible a change in consumers' shopping habits. It takes time to shop at a discount house. Often it is necessary to make two visits to the discount house and one to a regular store to decide on the make and model wanted. The limited workweek provides that time. Furthermore, widespread ownership of automobiles makes it possible for the consumer to go where the discount house happens to be.

- The redistribution of personal income during the past 15 years has helped to smooth the path of the discount house. There is now a considerable concentration of buying power in the hands of people who are not accustomed to much service.

Many members of this new middle-income group habitually buy in cramped, crowded quarters where furnishings and fixtures are unattractive. They are used to carrying their purchases home themselves. Consequently, the somewhat primitive facilities and services of the discount house do not offend them. They see no reason why they should pay more to buy in a pleasant atmosphere or for services they do not want.

Also, members of the professional group have felt the squeeze of higher income taxes. Many of them

turned to the discount house as a means of maintaining their high levels of living.

- The modern "do-it-yourself" attitude helped to make customers willing to buy in the discount house. In their garage workshops, many consumers learned to judge the quality of technical or semitechnical merchandise, which was previously a complete mystery to them. They are able to make installations and do repair work formerly beyond their powers. These changes fit perfectly into the atmosphere and philosophy of the discount house.

- Consumers have faith in manufacturers' brands. This, too, has made it easier for the discount house to build up its business. A TV set of a well-known brand in the original factory carton is the same whether it is bought in a discount house or in a cathedral of retailing on Fifth Avenue.

Currently, there are probably around 6,000 discount houses in the United States, selling more than \$30 billion worth of merchandise. Sales in all retail stores approach \$200 billion. Thus discounted goods represent something like 15 per cent of retail sales.

The above statistics can be quite misleading. They refer to the overall picture, but the discount houses are weak in some fields and strong in others. Discount houses have not yet significantly penetrated the automotive trade, restaurants and the food business (supermarkets). These three branches alone account for roughly \$100 billion in sales.

Merchant to middle class

On the other hand, the impact is strong in cities and in certain lines of merchandise. For example, some retail trade experts claim that 95 per cent of all electrical appliance sales in New York City are made by discount houses. On a national basis, they estimate that discount houses sell 70 per cent of all high-cost electrical appliances.

Because it typically sells for cash, the discount house is a *merchant to the middle class*. Middle- and upper-income families have ready access to the money needed to buy furniture and major appliances. The middle-income group alone—families with from \$4,500 to \$8,000 a

year—account for more than 40 per cent of consumer expenditures. Many low-income families—whether from necessity or ignorance—continue to pay list prices and exorbitant interest rates at "credit stores."

The merchandising techniques of the discount houses have been beautifully tailored to the needs of the goods-hungry middle class. After World War II, appliances and many types of home furnishings suddenly emerged as mass market "necessities." Yet they still bore the old "luxury" price tags and markups. So the discount houses simply stepped in.

How are the old-line retailers living up to the challenge of the discount house? In the beginning, old-line retailers considered discounting to be a flash in the pan. There was little reaction aside from angry words. Now the discount house concept is coming of age and has forced considerable changes.

Department stores threatened

The department stores are most seriously threatened. Originally, the contention was that appliances and other hard goods—the major area of discount house selling—were not important to department stores. This attitude is changing fast and many different methods are used to meet the competition.

Some department stores are fighting it out with the discount house, item by item, price by price. In most cases, however, the department stores have been unable to get lower than about 10 per cent above discount house prices. At this level, the department stores have sold at a substantial loss. After all, a store that requires a cumulative markup of almost 40 per cent cannot very well earn a net profit when it cuts prices to within 10 per cent of a store that needs a cumulative markup of around 20 per cent.

The reaction of some department stores has been to drop their major appliance categories. This retreat does not improve the store's competitive position because a department store is supposed to present a wide variety of goods to attract its total traffic. Every time a merchandise classification is dropped, or narrowed down, the store's total traffic is whittled away. This is serious be-

cause a department store's promotions do not produce more than 15 per cent of any day's traffic in the store. Furthermore, how many departments can a department store drop and still be a department store?

Other department stores have either dropped brands featured by discount houses, cut their assortments of these brands or given these brands less desirable space. As the discount houses tend to feature the top brands, this almost inevitably means that such department stores concentrate on secondary brands. In an age of self-selection, when department store salespeople are merely floor attendants, this is a strictly defeatist policy.

There has been some talk about department stores introducing their own brands. This would be another way to surrender the national brand market to the discount house. Department stores have made little progress with their own brands of hard goods. Soft goods *may* be another matter; although there too the discount house will soon be in an equally favorable position to promote its own brands, if it is so inclined.

Some department stores have tended to cut down on the promotion of national brands that are being pushed by the discount house. However, department stores in a single community compete with each other vigorously. When one department store soft-pedals promotion of a national brand, another department store is more than apt to promote that very brand heavily.

Shrewd shoppers

A few department stores have taken the position that if they come close to discount house prices on some major brands, they will create the impression that they too are low-price retailers. The trouble here is that patrons of discount houses are generally among the shrewdest shoppers. They tend to be keenly interested in and informed about retail values. They can usually tell a real from an apparent bargain.

The warehouse sale is becoming an established practice with a number of old-line department stores. Some stores actually haul their customers by buses from their downtown locations to warehouses. This

technique seems to be successful primarily because the department store is meeting and beating the discount house at its own game.

Many department stores are trying to compensate for the lower margins they are taking on competitively priced merchandise by fighting for larger or new types of concessions and allowances from manufacturers. In this, they have had some success.

Few concessions

But, generally speaking, there are few concessions department stores will get from suppliers or from distributors that discount houses will not also get. In the long run, it is possible that the discount house will average out better than the department store because its owners do a good deal of the buying, its buyers are better paid and more capable, and they can make fast decisions with a minimum of red tape.

A few department stores have concluded that they cannot compete successfully with the discount house on major appliances. So they are turning to leased department syndicates. In several instances, these lessees are themselves discount house operators. This operation has not proved successful in branded merchandise, but has done well in millinery and in service departments such as beauty shops.

Some department stores are going into higher price lines in order to get away from discount house competition. This is a self-defeating policy. If the department store is to remain a mass outlet, it simply cannot turn too strongly to higher priced lines, whether or not it can get them exclusively.

In such fields as appliances some department stores are making direct buying connections with the manufacturer. The discount house is, of

course, moving in this direction at least as fast. It seems safe to predict that discount retailing will lead more and more retailers into closer and direct buying arrangements with manufacturers.

Department stores are now keeping themselves informed about the prices charged in discount houses. This is quite a contrast from the attitude of three or four years ago when the discount house was ignored. Unfortunately, many department stores are only comparing prices. They would do better if they studied their competitors' management, and buying and selling methods.

Department stores believe that credit facilities are their best competitive weapon. But the discount house, too, is going in for credit and thus is blunting the edge of this particular weapon.

Complacent attitude

Variety chains are so far not too disturbed about competition from discount houses. But as discounters get more deeply into various soft goods (particularly textiles, health and beauty aids, small housewares and stationery), this complacent attitude will no doubt change.

Low-cost mass retailing is no longer a temporary phenomenon; it is as firmly established as high-margin mass retailing by department stores, food, drug, variety and specialty chains.

Yet its period of dynamic growth has hardly begun. A mere five years ago, few merchandising men would have predicted that a discount house would achieve an annual volume of \$100 million. After all, only a few long established mass retailers have built such an annual volume.

But in 1959 at least one discount house topped \$150 million sales, and

a dozen or so achieved over \$10 million. Practically all of this remarkable growth has taken place in five or six years.

Naturally, not all discount houses are successful. The thousands of small discount stores that opened in 1954 and 1955 started to thin out in 1956. This process continues. The small discount house is having a rough time. It can't buy right and therefore it can't sell right. It can't afford to move into the suburbs and must remain in old retail areas. Such areas are slowly losing their importance.

In 1959 there were fewer store-type discount outlets than in 1956. But the amount of merchandise moved by the discount houses exceeded the total moved by these outlets in any previous year.

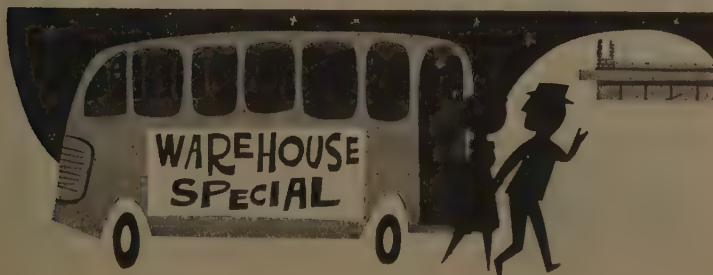
The newer store units of the discount houses are considerably more luxurious than their early outlets, some compare architecturally with the smaller branches of department stores. They are spacious and modern in design.

Like all mass retailers, discount houses hope that constantly increasing volume will more than balance the costs of more luxurious establishments, multiunit operations and more services. This has been the hope of each of our mass retailers!

Trend to soft goods

Another aspect of the growing-up process is an increase in the range of merchandise sold. Discount houses started primarily with major appliances. Then they added traffic appliances, housewares, furniture, rugs, home furnishings, food, beauty and health aids. The latest trend is toward soft goods—ready-to-wear, linens and domestics. The growth of established trade names in furniture, home furnishings, rugs and soft goods paves the way for discounting in these categories.

As the discount house becomes more firmly established with the public, its own store name becomes a guarantee of satisfaction. Originally, the public tended to deal with the utmost caution with the discount house. That attitude has not yet passed, but it is on the way out. Consequently, the major discount houses are no longer limited entirely to the retailing of known brands.



This has opened the way for the discount house to go into women's ready-to-wear, where powerful brand names are few and where the public is unable to determine values. Before long the discount house will market its own controlled brands in some categories. In fact, a few discount house brands have already appeared.

Discount houses tend to bring about a modern paradox—flexible pricing. This is extraordinary because one of advertising's great objectives was to get rid of phony prices and haggling over prices. It sought to assure one price to all, everywhere, all the time.

Our present system of retailing is no more on a one-price basis than is retailing in an oriental bazaar.

There are price promotions and price haggling, trade-ins, premiums and stamps. At least a million independent retailers practice "reciprocity discounting" for each other. There are courtesy discounts for relatives, for professional people, for friends, for friends of friends and for organized groups. This return to haggling and a multiprice system is the most fertile soil for the further growth of the discount operation.

Never in the history of modern brand advertising has the public, particularly the younger generation, been so thoroughly off-price conscious. Millions of young families have stocked their homes with possessions bought off list; they buy no other way. And the total of such families is constantly increasing.

To sum up, the war between discount houses and conventional retailers will end on neutral ground. As they have come out of their lofts and warehouses to openly challenge the department stores, the discount houses have begun to resemble department stores. For their part, the department stores have been forced to meet the competition. As frequently happens when competitive forces clash, all concerned are apt to benefit.

This is merely a way of saying what Alfred Marshall had in mind when he described the competitive system as a vehicle for giving individuals with "energy and resourcefulness" a chance to engage in activities that eventually result in overall "social gain." ■

Financing education

WHAT MONEY CAN AND CANNOT BUY

by **WERNER Z. HIRSCH**

■ YEAR BY YEAR we spend more on our schools. Yet educators, parents of school-age children, politicians and interested laymen daily express a deep concern over education in the United States. They point out that improvements are essential if the country is to meet the complex challenges it faces.

During this century the increase in expenditures for education in America is impressive. The cost of public primary and secondary education rose from less than \$200 million in 1900 to an expected \$14 billion in 1960. These figures reflect only current expenditures plus debt service; capital outlays are not included.

In spite of this huge increase, we do not seem to have enough funds for the kind of education that we believe we must provide our children. Why do we still fall short?

Part of the answer lies in the steady

inflation that has neutralized the effect of much of the increase. The price level of goods and services bought by schools has risen greatly since the turn of the century. Annual salaries for teachers, which account for an overwhelming part of school expenditures, have increased from an average of \$325 in 1900 to \$4,850 today—a fifteenfold increase still considered inadequate by 1960 standards.

The number of pupils has also grown enormously. Public school attendance has risen from slightly more than 10 million in 1900 to almost 32 million in 1960. A large part of this was in the high schools, where the cost of education is usually higher than in the primary schools. In 1900 only about three per cent of all pupils in public school were enrolled in high schools; the proportion in 1960 has risen to 23 per cent.

A further complication has been the addition of services unheard of 50 years ago. These include school bus transportation, school lunches (in school cafeterias) and health services. By 1959 we were spending about \$1.8 billion for such "auxiliary services" out of a \$12.7-billion total of educational expenditures.

These, then, are some of the factors involved in the substantial increase in expenditures. Very little has been left for improvements in the *quality* of education.

A yardstick we can apply to expenditures for education is to com-

pare them with per capita personal income. In 1900 per capita personal income was less than \$200; by 1959 it had risen to more than \$2,150. The amount of this income spent for education increased at about the rate of the income itself. In other words, the percentage of per capita income spent for education remained about the same during this period.

While this relatively low elasticity has marked our expenditures for education, there has been a much greater elasticity in expenditures for air conditioning, golf, pleasure boats and other luxuries.

These measurements imply that the public still puts too low a value on education. Indeed, if our expenditures reflect decisions as to what is most important to us in our society, then we regard education as little more than an unpleasant necessity. Yet surely an improvement of the quality of education is a national imperative.

To achieve this improved quality, political leadership of a high order is needed, as well as a clear understanding of the economic factors involved. If our society is to remain democratic, much effort must be directed to public education at the primary and secondary levels. Failure to do so could well mean inviting social and economic systems that put a low value on freedom.

As Adlai Stevenson said in his book, *What I Think*: "Bad education isn't cheap either. Its high costs

are paid from other budgets—for poverty and sickness and unemployment and juvenile delinquency. The question is not only 'What will an adequate education program cost?' The question is even more 'What is the cost of not having such a program?' "

If we agree on the need for improved education, how do we go about meeting it? We will need greater efficiency throughout the whole educational system as well as considerably larger appropriations of public funds.

Greater efficiency in education, some contend, can come from school district consolidation. This conclusion is drawn from the experience of industry. But the size of a school's physical plant, unlike the size of an industrial plant, often cannot be increased because of location. Even in large school districts, schools will have to be numerous and relatively small; parents object to having their children travel far to school.

Other economies from consolidation are similarly limited in their impact. The only factor purchased in large quantities in education is manpower, but concentration of manpower leads to unionization. This, in turn, increases costs. Teachers are unionized throughout the country, but in larger school districts maintenance workers and other non-teaching employees also tend to unionize.

Efficiency suffers

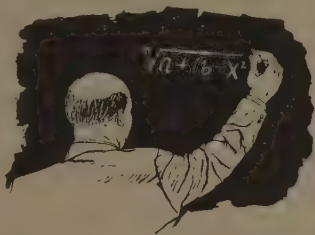
Large school districts are uneconomic for other reasons. For example, efficiency suffers through political patronage and top-heavy administration. Studies recently made in the St. Louis city-county area, in a number of other metropolitan areas and in the state of California appear to bear this out. Only where school districts are very small is consolidation likely to produce greater efficiency.

The productivity of our school systems has increased very little, if at all, since the turn of the century. The length of the school year has increased, but this has generally meant merely an increase in the number of days, rather than an improvement in the quality of education. Lengthening of the school year, by itself, is not sufficient.

Economies through greater efficiency in the operation of our schools are hard to achieve. What are the prospects of improving education by providing more funds?

If we continue to use the present methods of financing public education, the prospect of greater expenditures appears unlikely. Most school districts rely on property taxes; usually sales taxes are the source of payments made to school districts by state governments. In the face of general increases of the price level, particularly of teacher's salaries, dependence on property taxes can only lead to repeated fiscal crises; this is because reassessment of property values tends to lag behind price rises. Moreover, moves to increase sales taxes tend to run up against strong political resistance.

The fallacy of depending heavily on property taxes for public education was dramatically revealed last



year in a Houston suburb. The board of education set a tax rate of \$1.35 per \$100 of assessed valuation. It then approved a budget that required a tax rate of \$1.59. By April there was not enough money to pay teachers' salaries. Only an exceptional community effort managed to get the schools reopened after a two-week stalemate. How many school districts annually operate under such a policy is anyone's guess.

During the past 10 years, the general expenditures of state and local governments increased by an average of about 15 per cent a year (measured in current dollars). During the same period, the average increase of total current expenditures, plus debt service, for primary and secondary public education was about 17 per cent.

A "medium" projection made for the Joint Economic Committee of Congress suggested that if teacher salary increases are granted the total current expenditures for public pri-

mary and secondary education will advance (if our dollar holds its purchasing power) to about \$17.4 billion in 1965. This would be an increase of 58 per cent in seven years.

But will expenditures increase to this extent? Let us assume that the public attitude toward education and the ways of financing it remain unchanged. Let us also assume that there will be a three per cent annual increase in per capita personal income. Under these circumstances the revenue available for public education in 1965 would be \$15.3 billion. This would be a 39 per cent increase over 1958, but it would be about \$2.1 billion below the projected figure of \$17.4 billion.

Adequate information

Estimates of future needs, to be useful at all, must be based on adequate information. Only recently has adequate information begun to be available. Without it, we will find ourselves making forecasts similar to that of James Bryant Conant, in a *Harper's Magazine* article in 1938: "By 1960 or thereabouts we shall have stationary population. The expansive pressure on our schools will soon be gone."

What actually happened can be gathered from statistics released last year by Lawrence G. Derthick, U. S. Commissioner of Education. In 1959 some 140,500 classrooms were needed by primary and secondary schools, but only 68,440 were planned.

Improving public education will require a two-pronged attack. The efficiency of the school system must be improved, and it must achieve a greater purposefulness. As Dr. Henry T. Heald, President of the Ford Foundation, pointed out recently, not enough emphasis is being given to whether American education fits the modern world.

The introduction of uniform, country-wide achievement test programs and cost accounting methods can bring about greater efficiency in terms of higher quality education. If such uniform guides were available, we would be able to judge which educational programs offer the best results for the dollars spent.

Ralph Cordiner of the General Electric Co. voiced a widely held opinion about education when he said, "To my knowledge, there is

no other field in human endeavor which actually prides itself on declining productivity." The tendency to apply to schools methods which have been successful in industry has many drawbacks. There are, however, indications that educational productivity can be intelligently measured, and that sound comparisons between different school systems are possible.

A report on "Systems Analysis and Education" from the RAND Corporation discusses this problem. Its conclusions are that it is possible to determine statistically the complex of "inputs" of various educational systems, to measure the "outputs" in terms of tests, and to arrive at comparisons. In other words, given sufficient data, it might be possible for us to identify how much we spend and what we spend it for and to examine the results.

Using the same approach, we would be able to identify what we want an educational system to produce and to make a useful estimate of what it would cost. A major study in this field is being carried on by the American Institute for Research, financed by the U. S. Office of Education. For the first time enough data

will be gathered to allow comparative analysis of educational systems. Without this kind of research and evaluation our efforts to increase the productivity of education will be like groping through a fog.

However successful we may be in achieving greater efficiency and economy, substantial increases in expenditures will still be necessary. The funds that are needed will become available only if we increase the percentage of per capita personal income spent for education. To accomplish this, serious consideration must be given to policies that can change the public attitude toward the importance of obtaining education of higher quality than we now have.

Beyond this we must study policy changes which will shift at least part of the responsibility for financing public education from the local school district. We need to consider whether the state governments and possibly the federal government should bear a larger part of the load.

To sum up, greater expenditures on education and an improvement in its quality depend on a change in the attitude of the public. Such a shift of opinion hinges to a great

extent on the President of the United States, for he can provide leadership in facing the problem of education.

The President can focus the public's attention on the country's educational needs. He can keep this question in the forefront of people's minds long enough for significant progress to be achieved. This will only be possible if the Chief Executive gives education a greater priority than it has had in the past among the whole range of national concerns with which he deals.

If we are to maintain our traditions, federal support for education should probably take the form of federal contributions that match state and local outlays. These matching federal funds should be based on specific minimum criteria.

Among the first requirements is a minimum tax effort by the states seeking matching funds; another is a functioning program of equalization of educational opportunity on a national basis. Through such a program, effective minimums in education could be defined, and the great variations in the quality of education in different parts of the country could be reduced. ■

Labor-management relations in the Sixties

Fewer Strikes, Smaller Wage Hikes

by **OSCAR ORNATI**

■ DURING THE COMING DECADE, collective bargaining in our manufacturing industries will not make as many headlines as in the past. Barring a war or a major depression, we can expect the labor relations of the 1960s to be marked by increased government participation and less frequent strikes. Furthermore, new bargaining agencies will develop, and wages will move upward in a broad but unspectacular fashion.

The outlook in the nonmanufacturing sector, however, is less clear. There, the unions are not in as strong a position as in manufacturing. However, a drive to increase their strength may produce unexpected developments.

In the course of our history the government's role in economic and social affairs has increased. In government-union relations we find five phases. In the first, government repressed trade unions; in the second, from 1842 to 1916, it barely tolerated them. In the third, up to the New Deal, unions were protected. The fourth period, which encompasses the years of the Wagner Act, saw unions grow under government encouragement.

The fifth period began with the Taft-Hartley Act, bringing government control of unions. In 1959 the pattern of control solidified with the passage of the "Labor Management and Disclosure Act" — popularly

known as the Landrum-Griffin Act.

While some of those who supported the Landrum-Griffin Act may have sought to discredit unions, its impact on this decade's labor relations will, in the main, be constructive and stabilizing. The law is a landmark, not a turning point.

The Landrum-Griffin Act, it is true, denies some of the privileges of "private voluntary organization" to unions. However, it also strengthens union democracy and the concept of union leaders as trustees of their members' interests. This makes for fewer intraunion conflicts, more control by the union over its members and, consequently, more predictable contract enforcement by

unions. Thus, the law encourages the employer to recognize the union.

Under the Landrum-Griffin Act, unions register with the government and fulfill certain requirements; this results in an implicit government recognition of unions. Employer recognition will follow more readily than it did under the former legislation which, from the unions' point of view, was more favorable. While it has become commonplace to say that "unions are here to stay," actual recognition of this idea—in the sense of employers not trying to avoid unions whenever possible—is yet to come. Employer recognition of unions will grow throughout the 1960s.

It may appear paradoxical that increased union recognition should come in the wake of legislation curbing unions and at a time that union power is declining. During the last decade union membership has not grown at as fast a rate as the non-agricultural labor force. The realization that unions do not now, and are not likely in the future, to dominate the economy of the United States helps the process of their acceptance as a permanent aspect of the American scene.

Along with increasing union recognition, there is more economic planning and control by the government. Protective legislation and widened social security legislation, and—a point often missed—new instruments to settle disputes have also appeared. These developments will be followed by more realistic, cool, objective and hard negotiations.

While the role of government in settling disputes had traditionally been limited to the provision of conciliation services, the trend is shifting. Procedures which involve government are now available in various types of disputes, and there is pressure for more of the same. The Railway Labor Act, which provides for arbitration of disputes under a National Mediation Board, is recognized as far from perfect. Nevertheless, it is viewed as something that can be profitably copied.

The communications industry, for instance, has been studying ways to integrate its bargaining patterns within similar legislation. The White House Labor-Management

Conference for the first time in history gathered together representatives of labor and management who were actually "empowered to consider and develop guiding lines for just and harmonious labor-management relations." This is another example of a trend which, while not always obvious, is irreversible.

As in other parts of the world, labor relations in America involve Big Business, Big Labor and Big Government. Such tripartite labor relations will, by the end of the 1960s, be in full bloom. Summit negotiations through informal, *ad hoc* arrangements, which will not interfere with the details of negotiations at the company or plant level, will set the pattern for labor relations.

More participation

Unless organized labor loses all its vigor—and, temporary doldrums notwithstanding, this is not likely—tripartite labor relations will produce more participation by labor at all levels of government. In the coming decade, labor will be represented on the board of governors of the Federal Reserve Bank, as demanded by Walter Reuther last year. In addition, labor will be represented on most of the federal and state regulatory commissions as well as in other government agencies concerned with social and economic problems.

The year 1959 was second only to 1946 in the number of man-days lost through strikes. The steel strike was chiefly responsible, but there was conflict in other industries as well. Nevertheless, there is little doubt that the main trend is toward a declining willingness to strike.

Throughout the century, our strikes have been getting shorter and less frequent; most notably, the proportion of union members going on strike has been falling. Between 1900 and 1929, during any three-year period an average of more than 33 per cent of the country's union members went on strike. After 1929 the rate fell markedly. For instance, in the three-year period 1957-59, it was slightly below 10 per cent.

Many factors account for this decline. The increasing role of government is only one of them. The maturity of the unions, the conservatism of the worker, significant

changes in employer policies and attitudes, and the creation of bargaining arrangements which make for cooperation rather than conflict are other factors.

The years of full employment, the rise in living standards, general improvements in working conditions and the stability of unionism have all contributed to a developing conservatism among the workers. It is quite clear that as middle-class living standards spread, workers and their families resist strike-caused interruptions of their incomes.

As trade union officers and organizers have learned, the pressure to meet installment payments is a greater incentive to steady employment than was the pressure during a bygone era to avoid hunger.

Many years ago the late Sumner Slichter of Harvard noted that organized labor's greatest contribution would be felt through changes that it forced upon management. Alterations in managerial attitudes toward workers and unions have indeed been taking place. In the 1960s changes can be expected that stem from the broad development of personnel management since the 1920s.

Personnel and labor relations staffs have been nurtured on the belief—justified or not—that morale, loyalty and job satisfaction lead to greater efficiency. They have developed into a "third force" which represents labor within the very ranks of management.

The position of personnel men as staffers with specialized knowledge of labor problems permits them to exercise control and influence decisions, and often in ways that management may not realize. By now there are some 10,000 industrial and labor relations school graduates who are increasingly coming to occupy policy-making positions.

"Welfare concept"

The idea of personnel management as a "buffer" is not a new one. What is newer is the spread of personnel ideas throughout line management. While many efforts in "human relations in industry" were at first superficial and misdirected, there is little doubt that the "welfare concept" of employee relationships has taken hold.

Throughout the coming decade increased foreign competition, technological changes, and the need to expand existing markets and to create new ones will certainly affect labor-management relations, particularly in the manufacturing sector. To the extent that management will, in many instances, find it harder to translate wage increases into price rises, it will have to reduce costs.

The trend is already obvious in the hardening of prices of many manufactured products. U. S. Steel now employs more than 1,700 persons in efforts to develop new products and new production methods. When he released this information, U. S. Steel Chairman Roger M. Blough, while speaking of a "new decade of progress," noted the stern problems of competition. He also stated that his company had "not yet found the way to overcome the underlying causes of employment cost inflation which is a major factor in our great disadvantage in the race with foreign competition."

Impact of competition

The impact of competition from newer plants at home and abroad, and from newer products, insures that the 1960s will be a decade of relatively small wage increases. This competition, rather than the not always warranted claims of "employment cost inflation," will affect wage increases. The days of the 23-cent hourly pay increases are gone for good. The average for the 1960s will be more nearly in the six- to eight-cent range. For 1961 the pattern is already fixed, and 1962 and 1963 will not be very different.

The median settlement figures for negotiated wage increases in 1957, 1958 and 1959 were 10 cents, 8.7 cents and 8.8 cents respectively. In the first half of 1960, negotiated wage increases averaged only eight cents. A breakdown of this average shows that wage increases in manufacturing were less than those in the nonmanufacturing sectors.

The tendency for an increasing number of contracts to contain deferred wage increase clauses guarantees moderate pay boosts through 1963. It is worth noting that in 1958 only 24 per cent of all agreements provided for a deferred wage in-

crease. This figure rose to 33 per cent in 1959, and to almost 50 per cent thus far this year.

Does this pattern of modest wage increases mean a halt in the improved living standards of American workers? Definitely not. Such modest increases in money wages are consistent with the expectation of equal or larger increases in real wages. Wage increases averaging seven or eight cents for the next five years can be absorbed without price increases even if productivity were to continue at the relatively low pace of the last few years—two and one-half to three per cent annually. However, in many industries, productivity gains will average six per cent for 1960 and hover at this figure or higher for most of the decade.

The pressures of competition will be felt more critically in bargaining over working conditions and work rules than it will be felt in bargaining over wage demands. It is probable that the conflicts and the strikes of the next decade will be rooted in disagreements over job changes. In this area, management's more aggressive role in making demands for contractual changes is coming up against the workers' desire to protect their jobs.

In 1959 and 1960 unions and management appeared unwilling to bargain about job assignments and work rules. They are, nevertheless, slowly compelled to do so. Unions are already "in the dog house" with the general public over featherbedding and can expect little if any support from outside their ranks in maintaining restrictive practices. On the other hand, the employers have been addressing their arguments to newspaper readers rather than union officials, and this has not affected the position of the unions on work rules.

What will take place more and more will be the creation of new industry-wide agencies set up to cope with the problem of work rules. Industry-wide bargaining is gaining momentum. Informal collaboration among major producers in setting strategy characterized the 1958 and 1959 negotiations in the airplane, rubber and automobile industries.

Such collaboration helped reduce the union practice of playing off one company against another. The col-

laboration among producers also helped to reduce strikes and, at least in automobiles, led the union to work without a contract while the companies carefully maintained the amenities. In steel, industry-wide bargaining only led to a bitter and prolonged strike; yet out of this strike came developments foreshadowing the pattern of the 1960s.

The steel industry set up a Human Relations Research Committee to study rules, incentives and job classifications on an all-industry basis. Similar arrangements will become popular throughout American industry. Along with them will emerge joint committees on automation, training and unemployment.

The ease with which agreements can be reached through such instruments will vary with the economic prospects of the particular industry. Adjustments will be easier in industries with an expanding demand for their products. In all cases, competitive pressures, the new conservatism of the unions, their limited political power and the new institutions will help to bring about viable patterns of accommodation.

Adjustable situations

As for work rules and management prerogatives, much will depend on the way things are done. As indicated earlier, one can assume that management will move cautiously and stick to situations amenable to adjustment. To the extent that job changes will be linked with the retirement of current job holders, the inevitable decrease in manufacturing employment will occur without too much friction.

The predictions made here about labor-management relations in the 1960s are limited mainly to the manufacturing area. Regarding manufacturing industries, informed and worthwhile predictions can be made. During the next decade, however, the proportion of the labor force in the nonmanufacturing industries will increase. Up to the present, unions have had relatively little success in organizing the nonmanufacturing industries. For this reason it is still too early to do more than speculate on the development of labor-management relations in this area. ■

CHALLENGE NOTES

Economic Developments, Ideas and Phenomena

FREE ECONOMICS COURSE

When is government spending 'too much for price stability and business expansion? When is it too little for national security and growth?

One of the most encouraging aspects of this year's Presidential election campaign has been the willingness of both candidates to discuss these questions over the airwaves—even at the risk of wearying that large section of the population which is bored by economics. Rarely before in American politics have two Presidential candidates quoted so many statistics so often. If this keeps up, politicians will have to become economists—and economists may learn to become politicians.

But what is the voter getting out of this free course in economics? It is important not to exaggerate. The fact that the current political debate has often sounded like a convention of the American Economics Association does not mean that it has necessarily addressed itself to the most important economic issues of the campaign. And while common sense is a good defense against wildly partisan statements, it is quite helpless against statistics. Evaluating a statistical claim takes time and special knowledge—something that the average voter simply does not have.

Even so, the unusually high plane of economic discussion in this election, with its emphasis on the need for economic growth, is welcome. Economics is too important a subject to be left to the economists—and the politicians have performed a signal service in bringing it out into the open.

MORE TAX DEDUCTIONS

According to a recent study by the National Bureau of Economic Research, the nation's taxpayers are currently reporting over \$41 billion a year in personal deductions on their tax returns. This comes to $\frac{1}{4}$ of the tax base.

How important are these deductions in altering the way in which we allocate our incomes? Could our expenditures for philanthropy or medical care be increased by extending existing exemptions? More basically, are increased tax exemptions an alternative to increased public expenditures?

Prof. C. Harry Kahn of Rutgers University, the author of the study, presents some interesting but rather inconclusive evidence on this score. Individual gifts to philanthropic organizations, for example, have consistently averaged between one and two per cent of total income during the last 30 years. The standard deduction for philanthropic gifts introduced during the early 1940s has had no visible effect on the volume of such gifts.

Nor have tax exemptions encouraged private spending for medical care. However, since medical outlays of less than three per cent of income are not deductible, medical deductions constitute only a very small fraction (six per cent) of total medical expenditures.

These statistics do not foreclose the possibility that larger tax exemptions for health, educational and philanthropic expenditures might sizably increase individual spending in these fields.

Recent proposals to set no limit on the deductibility of voluntary health insurance premiums or to provide an additional allowance for expenditures on higher education are, as Dr. Kahn points out, a substitute for direct public expenditures in this field. Politicians may find it easier to raise money for needed services in this way than to increase budgetary appropriations.

In special cases, tax deductions may well be a useful device for getting needed services without unnecessarily enlarging government. As a general principle, changing resource allocation by means of tax

exemptions does not have much to commend it.

For one thing, as Norman Ture points out (*see page 8*), tax exemptions can rarely be limited to the objectives that writers of the law originally had in mind. Even more important, the revenue loss from tax deductions cannot be calculated with the same precision as the cost of additional government services. Too often, such exemptions hide the true cost of expanded services and encourage political irresponsibility.

HIDDEN SERVICES

The economy of postwar America presents us with an interesting paradox. On the one hand, the U.S. is today the only industrialized country in the world in which the bulk of the population is employed, not in producing goods, but in distributing and servicing goods. One would naturally expect, therefore, that individuals are spending a relatively larger proportion of their incomes for services.

And so they are—in inflated dollars. In 1956, consumer spending on services came to 31.1 per cent; last year the proportion had risen to 39.4 per cent. But in constant prices, the relative increase was much smaller—from 34.3 per cent to 37.8 per cent. And even this increase reflects small service expenditures during the war. Services, today, account for about the same proportion of our personal budgets as they did 30 years ago.

And yet, statistics can be misleading. We suspect that much of the consumer's spending on such things as food, automobiles, hi-fi sets, etc., goes into the "services" which are embodied into these goods—packaging, distribution, transportation, advertising, etc. It is these costs which have gone up fastest. The consumer, therefore, is spending more for services—even though they are the services which are often embodied in the price of "goods."

A MATTER OF TASTE

On the motivation research front: In its anxiety to reach the canine market, General Mills has suggested asking "an animal psychologist about what a dog thinks about animal flavors." So far, no psychologist has volunteered.—M.K.

COLSTON E. WARNE

President, Consumers Union



Protecting the Consumer

Q *It has been said that consumers make up the only important economic group in American society who remain unorganized and whose interests are not fully represented in government. Do you agree?*

A Yes, I think there can be no question about that. We have large-scale organizations of business, of labor and of agriculture. Washington office buildings are filled with lobbyists from organizations which claim to represent these producer groups. Consumers are conspicuous by their absence.

Q *How do you explain this?*

A It is just that the producer groups were the first to arrive on the scene. Business, labor and farmers were all unorganized at first. But as business grew larger it sought more from government, and, at a later stage in our history, the same was true of labor. Farm groups, or course, have sought special government assistance ever since their economic position became precarious toward the end of the 19th century. Small wonder that many of the Washington office buildings now house representatives of these groups. The Department of Commerce acts as a spokesman for business, the Department of Labor as a spokesman for labor, and the huge Department of Agriculture as a spokesman for the farmer.

Q *Do you favor the creation of a Department of Consumer Affairs as a way of redressing the balance?*

A I do. In fact, I believe that the creation of such an agency is well-nigh inevitable. It is just a matter of time. All that is needed is to bring together, under the roof of a Consumer Department, those agencies which have a consumer interest and concern.

Q *What specific government departments and agencies would you want to bring under such a Department of Consumer Affairs?*

A Well, at present all home economics and food research is carried on by the Department of Agriculture. Given the natural producer orientation of that department, the consumer's ultimate concern tends to be

rather neglected. That is why I should like to see this kind of work carried out largely by a Department of Consumer Affairs, as you put it.

Q *What other functions would you like to see performed by a Department of Consumer Affairs?*

A At present, it is the Department of Justice which initiates actions against companies which violate anti-trust statutes. Now, some of these cases are of direct concern to the consumer and should be handled by a body which is more directly responsible to him. Similarly, Federal Trade Commission proceedings against misleading and deceptive advertising could better be handled by a Department of Consumer Affairs. Finally, I would be in favor of transferring the Bureau of Standards from the Department of Commerce. Such a transfer would help to eliminate the prevailing business orientation of research in this field.

Q *But do consumers as a group really have important common interests? Although we are all consumers, don't most of us tend to identify ourselves with specific producer groups? Can we be made to feel as strongly about our role as consumer as we do about our role as businessman, worker or farmer?*

A During the 19th century you often heard the argument that businessmen were also workers. But this did not stop the steady growth of trade union organizations. To answer your question more directly, I do think that consumers have many common interests—for uniform standards of weights and measures, for unadulterated foods and drugs, for truthful advertising and packaging, and so on. Consumers are concerned over the current trend of selling goods on credit at terms which often are not plainly explained to the buyer. This entire business of warranties and contracts is of vital importance to consumers, also. Finally, consumers have a common interest in maintaining a truly competitive market base. They are opposed to artificial restraints on competition such as the fair trade laws. On all these issues, common interests are developing among consumers, both in the U. S. and in other countries.

Q *Are there any organizations at present that are consumer oriented in their work or representation?*

A There are a number of state and local organizations developing. There are also many general-purpose groups which often speak for the consumer—groups like The American Home Economics Association, The American Association of University Women, The General Federation of Womens Clubs, etc. When the chips are down, general-purpose groups of that sort can be counted on to speak for the consumer in Washington. But they are not meant to serve this specific purpose.

Q *How does the function of Consumers Union differ from these groups?*

A During our 25-year existence, our most important function has been the testing and appraisal of brand-name products. People have come to count on us for impartial, unbiased buying suggestions—especially in the durable goods field.

Q *Who provides the financial support of your organization?*

A Our organization takes money only from those who buy our services—namely, consumers.

Q *One criticism that has often been raised against the activities of Consumers Union is that you are, in fact, trying to make up the mind of the consumer for him.*

A I do not believe that this is a just criticism. We don't try to put ourselves in the place of the consumer and pinpoint exactly what is best for him. We know that consumers across the country have different needs and that each individual has to make up his own mind. What we try to do is to give the consumer the guidance of at least one impartial and expert opinion as a supplement to the usual sales blurbs.

Little correlation between quality and price

Q *But by emphasizing the quality of brands, don't you encourage the consumer to forget all about price?*

A No, I don't think so. We seek out the best buy and take into consideration both quality and price. Actually, there is relatively little correlation between the quality and the price of goods in today's market. In the field of automatic dishwashers, to take one recent Consumers Union test, our top recommendation was for a brand which sells for \$35 less than one of its competitors. Our tests found that the quality of the cheaper product was superior. This is quite common. Nowadays, price is not a very good guide to the quality of a purchase.

Q *How do you explain this?*

A I think that part of the answer lies in the extremely complicated technology we have created. Today, many everyday products are complex mechanisms which the average consumer does not understand very well. They have hidden technical attributes which can only be evaluated by a competent engineer who can actually peer inside the product. But quite apart from the complexity of many of our products, the consumer is con-

fronted with another problem. The list prices of manufacturers bear increasingly little relation to the actual purchase price of many products.

Q *How do you mean?*

A Well, you have the spread of discount houses which ignore the manufacturer's suggested list price and enable the consumer to "get it wholesale." Then you have the tremendous postwar expansion in consumer debt. Today, an increasing number of people buy on the installment plan and, thus, must pay the cash price plus a credit charge.

Q *If you are so concerned over the increasing meaninglessness of list prices, why do you oppose fair trade laws designed to maintain uniform list prices?*

A In the first place, the fair trade laws have been unsuccessful in keeping the market prices of durable goods near list prices—at least in urban areas. But they have been successful in maintaining the price of drugs. In fact, my main objection to fair trade laws as they apply to urban areas is that they have tended to keep the price of drugs at an artificially high level.

Q *How have the fair trade laws worked in rural areas?*

A Here, fair trade laws are generally enforced by small merchants. As a result, fair trade has pushed up the cost of living by maintaining over-all prices at an artificially high level. I think the time has come to scrap the fair trade laws completely.

Q *If, as you say, price is no longer a satisfactory guide to buying decisions, doesn't this play havoc with our entire notion of consumer sovereignty? If the consumer can no longer determine the value of products by price, is he still "king" of the market place?*

A I do believe that the consumer has lost much of his market power during the last 50 years. I think that the recent interest shown in the consumer movement springs in part from the growing sense of helplessness which today's buyer experiences when faced with a lot of new products he has never heard of before. How can he really judge the value of these products when he does not know their real attributes? Of course, the advertisers proliferate one-sided descriptions of the products of their clients. But trying to determine which advertiser comes closest to telling the truth on a given product has become well-nigh impossible.

Declaration of ingredients

Q *Can anything be done about this situation? Is it possible to establish objective product standards?*

A This is a real problem. In the long run, we may want to follow the pattern of Sweden. The Swedish Standards Association is asking manufacturers to put on their labels a declaration of the ingredients of their product. This declaration is then used to grade the product according to a uniform system of standards.

Q *How does this differ from our program of government grade labeling in such products as meat?*

A Our government sets a composite standard based on

COLSTON E. WARNE

a product's total attributes—grade A, B, C, and so on. Under the Swedish system, on the other hand, grades are allowed on *individual* attributes, such as color, shrinkage, and the like. In this way, the consumer can see at a glance how the product stands up. The system is policed by the Swedish Standards Association, not by the government, and it is not compulsory. Those companies who do not carry the Association's label are likely to lose much of their market. All in all, I believe that something like this might be a good substitute for our more general labeling procedures.

Q *How does one keep politics out of this kind of program? With a firm's success dependent on a high "grade," wouldn't great pressure be brought to bear on whatever administrative agency—public or private—was handling this sort of program?*

A Of course, there would be pressures, but this is true of other agencies in Washington—a city where scandals are not entirely unknown. On the other hand, I haven't noticed that the Bureau of Standards has been involved in any scandals. Their record has been pretty good. Indeed, the very competition of industry for official approval should help to keep malfeasance at a minimum. Each group is watching the other to make sure that nobody gets unfair preference. The more comprehensive such a system of standards is, the less likelihood there is of trouble. That is why scandals of this sort are much more common on the state than on the federal level.

Q *Dr. Warne, there is one aspect to this problem of standards that worries a good many people. What criteria are to be used in setting up the standards? How can we be sure that the people who test the products will be answering the kind of questions the consumer would like to ask?*

A Well, here at Consumers Union we receive about 150,000 replies a year to questions that we send our subscribers. In fact, we have set up a special projects division to take care of some of these questions. Our Public Service Projects Department, for example, is currently working on the problem of radioactive fallout in our foods—a study which no government agency has yet undertaken.

Q *Why is no government agency doing such work? Why should we delegate sweeping authority to government to set up standards when we cannot be certain that it will look into such important things as the effects of radioactive fallout on food?*

A It is the function of private organizations like Consumers Union to press for government activity in such vital areas. We set up pilot studies which, we hope, will eventually convince the government to undertake more comprehensive surveys. Once we convince the government that such studies are necessary, we are only too happy to move out.

Q *Do you also publicize the findings of other research organizations?*

A Yes. One of our more important functions is to act as a clearing house for studies which are of interest to the consumer. For example, we have been keeping track of the host of studies looking into the possible relationship between cigarette smoking and lung cancer. These studies have been conducted ever since the American Cancer Society first called the public's attention to this subject. Through our newly established international offices, Consumers Union has become the world's most important clearing house for consumer information.

Q *How effective have organizations like yours been in protecting the consumer? What is currently being done to increase the consumer's bargaining power?*

A As far as the over-all picture is concerned, I am afraid that very little is being done. On the one hand you have an \$11-billion to \$12-billion advertising industry designed to influence consumer choices toward particular products. But consumer groups have no comparable financial backing. Still, some important counter-efforts are developing. In various states a strong consumer council movement is emerging. California, Michigan and Minnesota all have a consumer association, and there is one developing in Massachusetts.

Effective consumer education

Q *What about consumer education? Is anything being done in this area?*

A Yes, a good deal is being done in this field, although I do not think the efforts go far enough. Advertisers often do not confine their selling efforts to appeals disseminated through the familiar communications media. They are also seeking to influence younger people by getting a great deal of promotional material into the schools. Now, I think that something has been done to help the schools to resist this pressure. The Council on Consumer Information, set up five years ago by the consumer education movement, is helping to give students a more impartial appraisal of values. In fact, I believe that consumer education is being taught more objectively in the schools than it used to be.

Q *Is anything being done about increasing consumer education on the subject of credit?*

A This, as we are gradually coming to realize, is a genuine problem. Neon signs on every main street are urging us to "borrow now and pay later." Consumer credit has become so commonplace that many people see nothing odd about being urged to borrow instead of to save in order to establish a credit rating. I think the public is beginning to have serious misgivings about this trend. Bills have been introduced at both the federal and state level which would force finance companies and other credit agencies to give more accurate information on their rates. There is also a movement afoot to set maximum interest rates on consumer credit. These moves should help to prevent gross exploitation.

Q *Are you satisfied with these signs of progress?*

A No, I am not. Much more needs to be done, and no one at Consumers Union is enough of a Pollyanna to suggest that we have found an answer to all these problems. We are just beginning.

Effect of consumer credit

Q But if organizations like yours are successful in giving the consumer greater bargaining power, might not the economy as a whole be adversely affected? To the extent that our postwar expansion has been sparked by the emergence of a mass market for all kinds of expensive, durable goods, is there not a danger that a sharp reduction in consumer credit or a firmer resistance to the advertisers' sales pitch might plunge us into a serious economic depression?

A Quite the contrary. On the question of consumer credit, I have always had a certain skepticism about the basic soundness of any economy that needs a large infusion of consumer credit to keep it growing. No doubt there are temporary benefits in running up a high level of consumer debt. But even here I suspect that the stimulating effect of consumer credit reflects inadequacies in the distribution of incomes and tax loads.

Q In what way?

A Consumer credit is one method whereby the savings of the well-to-do may be used to expand the purchasing power of the less well-to-do. When a finance company lends Joe Doakes money to buy a spanking new 1961 automobile, it is in a sense putting money not needed by one group at the disposal of Doakes and others like him who don't have the cash to buy a new car. Indeed, they are encouraged to buy. In many respects, this system works beautifully. What I am suggesting is that an economy with a wider distribution of incomes might still be able to provide cars for the masses without increasing the flow of consumer debt. I believe that a shift in the tax burden might accomplish this end.

Q But you do not recommend a drastic reduction in consumer debt?

A No, I do not. Obviously this could cause considerable damage to key industries—such as the automobile industry—which are closely tied to consumer credit. Indeed, I hope you will not misconstrue my rather negative thoughts on this subject. Most surveys on consumer credit indicate that it is the middle, and not the lower, income groups who have increased their level of indebtedness most. Judging from the repayment record to date, consumer credit does not seem to have imposed very heavy burdens on the consumer thus far. My fear is that, unless we slow down, things may get out of hand.

Q How about advertising? Does it have a stabilizing role in our economy?

A I do not believe that advertising has a stabilizing influence. During boom periods, when we want to check inflation, advertising expenditures are usually at a peak; during periods of recession, when markets are scanty and advertising might play an important role in over-

coming consumer resistance, advertising budgets are usually cut back.

Q In other words, you do not believe that economic growth depends on irrational consumer behavior?

A I most certainly do not. At present we are in the curious position of seeming to move towards both rationality and irrationality in consumer behavior.

Q How do you mean?

A At one end of the spectrum we have a large and, I believe, growing group of canny consumers who are extremely price conscious and keep up with latest product developments. Many of them belong to consumer organizations like ours.

Q What about the others?

A Along with this large group of wise consumers, there is another group of consumers whose behavior is quite irrational. This is particularly true in the field of health where people are under tremendous pressure to yield to fake cold cures and other forms of medication.

Q Well, who is winning, the wise or the foolish?

A I really don't know. The surveys we have made suggest that the degree of deliberation that goes into consumer buying decisions is not increasing very rapidly. On the other hand, it is increasing somewhat—and that is surely progress.

The sophisticated consumer

Q How does the American consumer compare with consumers elsewhere in the world? Do consumers get more sophisticated as an economy becomes technologically more advanced?

A Not necessarily. I think that consumers in some European countries are far more sophisticated than we are, and the reason for this, at least in part, is that many European countries have not yet developed our mass retailing system. In Europe, the market still gives the consumer a good deal of accurate information about products. But when the American consumer walks into one of our huge supermarkets, she has to make her choices on the basis of fancy packages and impersonal sales messages. Nine times out of ten she does not even meet the sales clerk. Making rational buying decisions under such a setup is infinitely more difficult than it is in the small stores which still prevail in many European countries, where the owner of the store is in close touch with his customers. Under such a simple retail system, the manufacturer cannot "pre-sell" the housewife before she enters the store. Countries like Norway or Denmark seem to have more sophisticated consumers although they do not have our fancy shopping centers.

Q Well, isn't there another side to this? Hasn't the modern supermarket also provided the shopper with many savings and conveniences he would not otherwise enjoy?

A This was certainly true in the early days of supermarkets. In those days, supermarkets were huge, simple

warehouses with inexpensive shelves, unostentatious displays and simple checkout counters with a minimum of sales clerks. As a result, retailing costs were cut by as much as half.

Q *I take it you are suggesting this has changed?*

A Supermarkets have ceased being simple and inexpensive. They have increased the number of brands they carry. They play soft music. They have added new "services"—many of them of dubious value—and in general have increased their overhead costs. At the same time their numbers have multiplied so that overhead costs *per customer* have also increased. In fact, the only thing that has saved many supermarkets from bankruptcy has been a growing tendency to encroach on the territory of druggists and others carrying high margin merchandise. In many cases, this is the only way supermarkets can cover low profits or losses in their traditional grocery lines.

Role of motivational research

Q *In this connection, how do you regard the increasing use of motivational research in advertising? Isn't this a deliberate attempt by the advertiser to make the consumer buy irrationally?*

A It certainly is, and it is something that organizations like ours are very much concerned about. On the other hand, I believe that if motivational research is widely used, the results may be rather different from what its practitioners expect. If you have competing companies urging the consumer to buy the same product for different reasons, the effect will be to confuse and bewilder him. And once the consumer is bewildered, he is on the threshold of intelligent behavior. This is where organizations like Consumers Union enter into the picture. We help consumers to make rational and objective buying decisions.

Q *Still, there are limits to what one organization can do. Assuming that your recommendation is adopted and a special Department of Consumer Affairs is set up, what could or should such a department do to improve the rationality of consumer decisions?*

A I think the basic need is for some agency in government to articulate and defend the consumer viewpoint. The consumer has a vital interest in such questions as product standards, utility rate setting and codes to govern the output of communications media, especially TV. But in these areas the consumer cannot speak for himself. He needs expert technical counsel to counter the arguments of the high-priced attorneys who represent producer groups before the various regulatory commissions.

Q *But why do you need a government agency to articulate and defend the consumer's interest?*

A The answer is largely political. Consumers should have some agency in government charged with pro-

tecting their interests in the same way that the Department of Agriculture is charged with protecting the interests of the farmer.

Q *What other functions could a Department of Consumer Affairs perform?*

A An extremely important function would be to bring together the great network of government information on consumer affairs that is already available—if you can find it. At present such information is scattered throughout all the government departments and agencies. Now, if all this information were to come out through one department, people would know where to write and get it. As it is, many excellent pamphlets in Washington move directly from the printer to the wastepaper basket.

Q *Couldn't such an agency also suggest the initiation of new laws in the consumer field?*

A I should hope that a Department of Consumer Affairs would play a very active role in recommending legislation. Take the Federal Trade Commission which, until quite recently, seemed to be in a long 40-year sleep. Now, if the FTC were brought under a Department of Consumer Affairs, it would have its work cut out for it. In particular, I would hope that its mandate would be strengthened to enable it to put a quick stop to many business practices which tend to deceive the consumer.

Q *Wouldn't the creation of such a government department constitute an invasion of the rights of businessmen to run their businesses as they see fit? To what extent is your proposal merely one other way of restricting and limiting American free enterprise?*

A I do not feel that this argument has any merit. Of course, I wouldn't expect business groups to endorse a Department of Consumer Affairs, any more than they endorsed the creation of the Department of Labor or the Labor Relations Board. There can be no question that such a proposal would restrict business to some extent. On the other hand, I think that it would provide a better climate for business.

Q *In what way?*

A Mainly, by increasing public confidence in business, and in this way reducing the pressure for restrictive legislation in other areas. It would also protect companies who are telling the truth about their products from competitors who make over-exuberant claims. But the basic reason why we need a Department of Consumer Affairs is not that it will help business, but that in an era of business concentration, mass retailing and administered prices, the consumer needs legislative and administered protection. The disadvantage of creating one more government agency is offset by increasing consumer knowledge and encouraging a greater degree of competition in our economic system.

Q *This would inevitably lead to a special Congressional Committee on Consumer Affairs, would it not?*

A That doesn't worry me. In fact, we supported the

so-called Gillette proposal of 1952, named for Senator Guy M. Gillette (D-Iowa), which called for the creation of just such a committee. Of course, several Congressional committees, such as those headed by Representative Blatnik (D-Minn.) and Senator Kefauver (D-Tenn.), have carried on important investigations in the consumer field. But such problems should receive the systematic attention of *one* special Congressional committee. They shouldn't be handled in a random, piecemeal fashion.

Responsibility of the states

Q *Couldn't many of the consumer problems you have mentioned be tackled at the state and local level?*

A They can certainly be handled at the state level. The protection of consumer interests is already very largely in state hands. Weights and measures are almost completely administered by the states. Food and drug administration is partly in state and partly in federal hands, and the states have major jurisdiction over fair trade laws. Since the states enjoy so much power in this area, there is a clear need for the creation of consumer departments at the state level.

Q *But your view is that there is still a need for expanding the federal government's role in this area?*

A There most certainly is. Standards, for example, should be uniform not only from state to state, but from nation to nation. The U. S. should seek to integrate its standard measures with those of the rest of the world. I am certain that sooner or later we shall have to replace our hodge-podge of standard measures with the metric system. A century and a quarter has passed since the John Quincy Adams report recommended such a step. The time has clearly come to devise some system of measurement which will enable us to keep in step with the rest of the world.

Q *What can be done outside of government to improve the consumer's position in our economy?*

A Of course, I believe that there will always be a function for organizations like Consumers Union, but I believe that there is plenty of room for other kinds of organizations.

Q *Does Consumers Union represent consumers, or is it primarily a service organization?*

A A little of each. We do have an annual election in which two candidates run for each seat on our Board of Directors. We send elaborate questionnaires to subscribers in order to find out what they want us to investigate. On the other hand, we are also a service organization. We have an educational service. We have given grants to organizations like The National Bureau of Economic Research for studies on consumer expectations. We have special research and educational projects in progress on consumer standards among Puerto Ricans and Negroes, among the aged, and so forth.

Q *Do you think that the consumer education programs can help in the fight against inflation?*

A In a general way, they certainly can. Better information on products will undoubtedly help consumers to get more value for their dollar. As a result, they should be able to salt away a greater portion of their income in savings. This is especially true in boom periods when sophisticated and cost-conscious consumers are unlikely to be drawn into hysterical buying sprees. The buying patterns of knowledgeable consumers will generally be in a countercyclical direction.

Q *Dr. Warne, as you know, many economists are concerned over what they call our "misallocation of resources"—our apparent preference for expensive durable goods over such things as education, medical care, and so on. Do you believe that an increase in the number of educated, aware consumers would lead to a change in our spending habits?*

A There can be no question about it. Every survey that has ever been made of our membership, for example, indicated their concern over basic services. Such people, moreover, tend to be patternmakers in consumer behavior. This means that if our members become concerned over air pollution, radioactive fallout or inadequate health care, their concern will exert great influence in their communities. Beyond this, I think it is obvious that if people as private consumers can evaluate a good buy, they can also, as members of a group, understand the value of socially useful expenditures.

Q *But you believe that there is room for more organizations which specialize in the political representation of consumer interests?*

A Yes, I think so. Consumers Union cannot get involved in politics because we are a tax-exempt group. We can't go down to Washington and maintain a lobby of any sort. But there are other groups emerging which will, in time, be able to give the consumer this kind of representation.

Q *So far, we have talked of group activities. What can the individual do in order to become a more intelligent consumer?*

A This is a natural place for me to make a plug for *Consumer Reports*. Certainly, the aim of our publication is to provide consumers with the kind of information they need in order to make sensible buying decisions. But, apart from the work that we are doing, there is a growing literature in this field. The consumer should seek out expert and objective advice—and such advice can often come from technically informed neighbors and friends. Above all, the consumer should be watchful, and even a little suspicious, of commercial attempts to rule him.

Q *But you do not believe that such individual self-help is enough.*

A I'm afraid not. Just as the 19th-century worker needed group action in order to protect his interests, so the 20th-century consumer needs organized representation. And, sooner or later, he is going to get it.

Q *Thank you, Dr. Warne. ■*

The Deluxe Economy Model

by STANLEY C. HOLLANDER

■ CRUDE MOTOR COURTS give way to lavish motels. Paperbound books grow thicker, more intellectual and more expensive. Compact cars are readied in the prestige lines as well as among the Big Three. Outboard motors, once considered the cheap "putt-putts" of boating, appear in powerful, costly, 75-horsepower models. Supermarkets and discount houses improve their decor, and the frozen food industry begins to process *lobster thermidor* and *crepes suzette* as well as hamburger and codfish dinners. Products and services that supposedly attracted customers solely because they were inexpensive are being offered in an increasingly wide assortment of deluxe models.

This movement runs counter to the standard pattern for the introduction and popularization of new products. Most new products, it is true, never develop very much at all because consumer veto power is exercised over the great majority of new offerings. But those products that succeed usually go through a trickle-down, spreading-out pattern, becoming both cheaper and more popular as time goes on.

The early models are usually produced only in limited quantities. These are sold at high prices to the most eager buyers, the people who are willing to pay a premium for the prestige of being first to have something new. Their reactions often provide a pretty good indication of the product's likely fate in the larger, popular-priced market. Price reductions and widening acceptance then go hand in hand to produce the abundance of a modern mass-consumption society.

Today, however, the "economy" models are being steadily upgraded, in a sort of trickle-up process. How can we account for this movement which seems to run directly contrary

to the standard pattern? Has it become stylish, as one well-known fashion maker declares, to try to live down to the Joneses? Has the American public turned into a group of Marie Antoinettes, playing at being milkmaids and demanding silver-plated milk pails for the pretense?

Before we attempt to answer these questions, perhaps we should ask another. Why, in the past, was the trickle-down process in the marketing of new products considered a necessary standard practice?

Cost considerations often dictate this standard pattern. The risks involved in bringing out new products lead many manufacturers to charge a large share of their development, tooling and promotional costs against the early production runs. In a sense this is a conservative approach, since the first units are often the only ones that will be made. Also, imitators will soon appear, and since the new competitors will not have incurred the pioneer's early costs, they may soon force his prices down.

Skeptical and conservative

Even more significant are the economies of mass production that come with widening acceptance. Development of a mass market takes time. Skeptical and conservative consumers, who usually far outnumber the eager buyers, are not converted overnight.

Profound changes are often needed before the new product becomes suitable to mass consumption. For example, widespread electrification of homes was needed to create mass markets for electrical appliances. Widespread use of automobiles required such product improvements as the enclosed body and the self-starter as well as the development of a vast highway network. Thus, production costs may not reach their minimum until many years after

the first models have appeared.

Even when costs are low right from the start, the innovator may decide to take advantage of his monopoly position and of the willingness of eager buyers to pay almost any price for his new product. After he has exhausted the first rush of demand at one level, he will reduce his price a notch to obtain the next batch of customers, and so on down the demand curve.

This process is known as "skimming the cream" and is strikingly illustrated by what happened when two manufacturers raced to place ball-point pens in a product-hungry market in 1945. The first manufacturer priced his pens to retail at \$12.50, although his production costs were only a small fraction of that figure. His competitor entered the market at \$15. Eighteen months later, after the initial excitement had died down, the pens of both firms retailed for one dollar.

The standard trickle-down, spreading out pattern of product introduction also conforms to the usual concept of the fashion cycle. Practically all theories of fashion since Veblen have held that the poor masses are consumed with a burning desire to ape the well-to-do in every possible aspect of appearance and manner of living.

At the same time, the elite have an equally burning desire to avoid any resemblance to the masses. So, according to these theories, the style setter must be sold first if mass acceptance is to be obtained later. And, presumably, the style leaders will be attracted only to products that are both new and expensive.

Today, however, the elite are clamoring for economy products—or at least for deluxe versions of them. So we get back to our original question: How do we account for this curious new turn in product mar-

keting? The trickle-down process remains the standard pattern. But what explains the fact that the trickle-up process, in which products start cheap and become expensive, has superseded the normal trickle-down process in many areas?

Some leading motivational researchers, such as Ernest Dichter and Louis Cheskin, feel that we suffer guilt feelings over our prosperity. According to this view, we are torn between the desire to spend like Diamond Jim Brady and the feeling that we ought to heed the thrifty wisdom of Benjamin Franklin's Poor Richard. Diamond Jim triumphs in the budgetary process, but Poor Richard makes us seek rationalizations and products that will reduce our sense of guilt.

Human motivations are complex and not susceptible to easy generalizations. Undoubtedly, guilt feelings and a certain sense of discomfort with ostentatious display have their influence in modern product choice. The wealthiest child in a school classroom often wishes he were as poor as some of his mates. His overt behavior in adult years may display an amazing recovery from this early embarrassment with riches, but the subconscious influence often persists.

We all know that many motorists will defend their choice of cars, compact or otherwise, on the grounds of gasoline economy. In some cases these savings are significant, but often mileage is only a rationalization that demonstrates how strongly the motorist feels obliged to appear money-wise and price-conscious. After all, a motorist who drives the normal 10,000 miles a year and stretches his fuel performance from 15 miles per gallon to 20—probably an unusual gain—saves only about 160 gallons, or \$50, per year.

Relaxed, casual living

However, much of the movement toward deluxe versions of economy products can be traced to a simpler source: the requirements for relaxed, casual living in a highly prosperous, highly mechanized society where the prosperity is well diffused among substantial portions of the population.

The luxury motel is a perfect example of this. The roadside tourist

camps first appeared in substantial numbers during the depression days. Their cabins were crude, ramshackle affairs, often without inside plumbing and other creature comforts. Their sole appeal was that they were inexpensive.

And just as grocers thought the ramshackle supermarket of the depression had merely a temporary price advantage that would disappear when prosperity returned, so hotel men thought the tourist court was a passing fad. Thus their highway billboards proclaimed: "There's nothing like staying in a *real* hotel."

But as the grocery industry knows full well today, the customer preferred self-service for many reasons besides that of price. Browsing among the open shelves of the supermarket is apparently easier, more convenient and more relaxing to many shoppers than waiting for the services of the grocery clerk.

Roadside accommodation provides similar advantages. The great wave



of hotel construction that took place in this country during the late 19th and early 20th centuries was geared to the needs of railroad passengers. But the increase in the number of autos switched many travelers from the rails to the highways. In addition, each car added to the traffic congestion of the city streets and compounded the difficulty of parking.

Moreover, the widespread use of the automobile encouraged suburbanization, thereby taking city congestion farther out into the country and making downtown hotels even less accessible to the intercity motorist. The motel gained the supreme

attractions of convenient location and parking.

Both the motel and the shopping center share another attraction. This is the lure of informality. Automobile travel, especially during the summer, is not conducive to the utmost formality of dress. The Bermuda shorts and the sport shirt that are the uniform of the summer motorist seem a little out of place in the Grand Palace Hotel, just as they are in the ornate aisles of the Bon Ton Department Store.

Logical adaptation

The compact car, in both its luxury and its economy versions, may also be regarded as a logical adaptation to congestion on the highway and in the parking lot. For a long time the major automobile producers discussed the demand for smaller cars in terms of a demand for a cheaper car. In the light of this analysis they scoffed at the opportunities for selling compact models.

They pointed out that just about as much labor went into a small car as into a big one of comparable quality and that the savings in materials were relatively unimportant. A good secondhand car, they constantly reminded us, involved a much smaller investment for the economy-minded consumer than would any new car with a shortened wheelbase.

In the light of the assumption that small car demand was the same as cheap car demand, they were right. But after a time the increasing length of automobiles and the absurdity of their tailfins provoked a style reaction. It is easy to see now that much of the small car market has not been a low-price market.

With the possible exception of the Volkswagen (a car that has become a fetish among its devotees), the truly stripped models have not been as popular as the luxury-tinged compacts. The Rambler has outsold its cheaper cousin, the American, by a rate of at least three to one. And long before Ford marketed its Falcons and its Comets, it was selling the highly successful luxury compact, the Thunderbird. People probably bought the T-Birds for many reasons, but few seem to have selected that sporty car out of a conscious or subconscious desire to appear poverty stricken.

When everybody's car became larger and longer than the Rolls Royce and the stately old Pierce-Arrow, sheer bulk lost its prestige value. Spaciousness has its advantages for highway travel, but compactness has basic merits in city traffic and in parking. Since many cars are used mainly in urban and suburban areas, there is no necessary correlation between the size of the car a consumer may need and its grade of upholstery.

While automobiles are getting smaller, pleasure boats—particularly outboards—seem to be getting larger. Marine experts (and this group includes everyone who owns a yachting cap) are totally unable to agree upon the relative safety, efficiency, comfort and seaworthiness of inboard and outboard engines.

However, practically everyone does seem to concede that the new large outboard boats are cheaper and can be used more flexibly than inboards of comparable size. Hulls designed for outboard motors usually weigh considerably less than similar inboard models. Heavy power transmission equipment is eliminated and, of course, the motor itself is easy to detach. The consequent weight reduction makes it relatively easy to tow an outboard behind a passenger car or station wagon on a vacation trip; it also eases the problem of hauling the boat out of the water for transport or on-shore housing.

In spite of their advantages for economy-minded boatmen, outboard engines were generally limited to very small pleasure craft until about 1950. Then the invention of satisfactory automobile-type self-starters and remote control steering apparatus made larger applications practicable. Now outboard motors are available in powerful, fancy and expensive versions.

Up and down

In a sense this is an example of the trickle-up pattern. But the upgrading of the economy motor has, in turn, permitted the production of cheaper cabin cruisers and runabouts. The total package—hull, equipment and motive power—has trickled down (perhaps an unfortunate metaphor in the case of boats) rather than trickled up.

Within the last five or six years a

number of university presses and book publishers have begun to print increasing numbers of so-called quality paperbacks, retailing at prices ranging from 95 cents to \$2.50. Since we have grown so accustomed to paying 25 cents, 35 cents and occasionally 50 cents for paperback reprints in drugstores and supermarkets, the new books seem to present another instance of an economy product being upgraded and made more costly.

Size and methods

However, the quality paperbacks differ considerably from the cheaper publications. The difference is not necessarily a matter of literary merit, although the average is considerably

perback business. A 25-cent paperback probably will not be very profitable unless its sales hit a minimum of 100,000 copies. Even more sales may be required to recover investment if the book is long, or printed on a good grade of paper or if the publisher has paid a premium for reprint rights.

High-traffic locations

The most successful paperbacks sell in phenomenal quantities. Pocket Books, the modern pioneer in the field, has printed 37 mystery stories by Earle Stanley Gardner that have sold over one million copies apiece. Worried parents have bought over 10 million copies of Dr. Spock's fa-



higher among the more expensive volumes. The difference lies in the size of the markets for the two types of books and in the methods used to reach those markets.

Traditional publishing and book-selling methods simply do not provide the sales volume needed to make the 25-cent books practicable. University presses, which are partially supported by their host institutions, have to sell about 3,000 copies of a book to break even. A commercial publisher has to sell perhaps 5,000 to 8,000 copies of the average \$4 novel to recover his investment.

Unfortunately, many titles fail to make the grade. More than half of the books that university presses published in the years 1955-57, for example, were printed in editions of less than 1,300 copies. Only a few of the novels published each year in hard covers reach sales of 10,000 copies.

These figures are far below the break-even point in the popular pa-

perback guide to baby and child care.

Mass sales of this sort could not be achieved through bookstores. The average consumer does not visit a bookstore from one year to the next. The 25-cent books must be on display in high-traffic locations such as newsstands, drugstores and supermarkets, where they may be bought on impulse. Also, the books selected for this trade must have mass appeal. They may be meritorious or meretricious, but they must be capable of attracting literally hundreds of thousands of purchasers.

The quality paperbacks are designed for smaller audiences and more specialized interests than are the mass-market books. They are distributed mainly through bookstores and other selected outlets. The break-even point for the average quality paperback is somewhere between 10,000 and 20,000 copies. Some of them, however, sell much better than this. David Riesman's

The Lonely Crowd and William F. Whyte's *The Organization Man*, for instance, have been best sellers.

The quality paperback serves mainly as an attractive and inexpensive means of presenting a book that otherwise would be available only in cloth, often at two to four times the price. The economies of mass production have been brought to serious literature. This development illustrates the trickle-down process at its very best.

The paper binding, however, is not the direct source of the quality paperback's inexpensiveness. All of the materials, including the paper and binding, in a book make up less than one-third of its cost to the publisher. The substitution of paper for cloth binding is a relatively minor economy.

The real advantage is that the attractive, informal, convenient paper editions appeal to so many more purchasers. To cite an extreme example, last year Columbia University Bookstore added a paperbound edition of Bertrand Russell's *Problems of Philosophy* to its shelves. The paperback sold more copies at \$1.25 in two months than a clothbound edition of the same book had sold in years at \$1.20.

Patterns and cycles

Most types of retailing in America seem to have gone through a development pattern that differs markedly from the product cycles we have just examined. According to available evidence, most new methods of retailing have appeared upon the American scene as low-cost, low-margin, low-prestige outlets, and then have gradually acquired both increased status and higher operating costs.

For example, when department stores first appeared, critics felt that they would drive all independent merchants out of business. But in time department store operating costs rose, and average margins were increased from about 25 per cent to 36 per cent of retail sales. Then, in turn, department store retailing became threatened by discount house competition.

In a continuation of this cycle, discount house margins have risen in recent years, and many discount merchants today are worried about com-

petition from expanded nonfood departments in giant supermarkets. A similar pattern of low-margin entry and then increasing costliness seems to have held true for mail-order houses, variety stores, super gasoline stations and many other outlets.

"Wheel of retailing"

Prof. M. P. McNair of Harvard has called this pattern "the wheel of retailing." It is not necessarily a trickle-up process in the sense of institutions appealing first to the masses and then ultimately to the elite customers.

Available evidence indicates that, from the beginning, upper-income consumers patronized the discount houses as eagerly or more eagerly than low-income customers did. High-income consumers may be even more money conscious than people with lower incomes. They also have better access to discount sources, and they do not need the credit services and other privileges of conventional retailing.

The differences between the retail development pattern and the product development pattern may lie in the fact that most of the significant retailing innovations in recent history have not involved the creation of new services. The basic concepts and utilities of retailing have been known since antiquity.

The new types of retailing have merely provided more economical and more efficient ways of furnishing a traditional service. The innovators have been forced to enter the market as direct competitors of existing institutions and, in most cases, they have had to accept reduced margins to attract trade.

As the years go on, however, a

number of factors tend to bring margins in the new outlets up to the level of the older competitors. The innovators gradually apply their techniques to a wider and wider range of goods; variety stores add lunch counters, supermarkets add nonfoods, and discount houses add ready-to-wear. Such changes often increase store-wide margins, even though the cost of handling specific items may not change.

Part of the increase in average margins is simply due to a deterioration of managerial skill. After the stores become successful, the innovators, or their heirs, relax some of their early vigilance over costs.

Innovation and imitation

Strangely enough, competition can cause some other increases in margins. Innovation attracts imitation. Price advantages become obscured, and the low-margin merchants begin adding services to attract and retain trade. Eventually margins are adjusted to pay for the new services.

Long-run economic growth and changes in consumer income probably explain some of the other increases in retail margins. Some merchants have found it profitable to add services and amenities as their customers have become more prosperous. Interestingly enough, the upward adjustments have always seemed to provide room for the entry of new low-margin outlets.

More significant than any specific pattern of change and development is the fact of change itself. Our economy will remain vital as long as it provides ample opportunity for experimentation with all forms of development—in products, in services and in marketing methods. ■

MOTELS MOVE AHEAD

Bridal suites, swimming pools, dog kennels and baby sitters are features found in an increasing number of motels. As the number of motels grows, luxurious ones are becoming more and more common. A suite that rents at \$130 a day is reported to be the most expensive accommodation available. Facilities for banquets are of growing importance.

Around the major cities motel construction is booming. They are being built near airports and in resort areas. The increase in the number of motels in recent years has been extraordinary. In 1948 there were about 25,000 in the United States; today there are approximately 62,000 according to *American Motel Magazine*. In contrast, during the same period only a handful of hotels have been opened.

AT SIXES AND SEVENS

by WILLIAM DIEBOLD, JR.

■ ONE OF THE MOST consistent elements in postwar American foreign policy has been support for Western European integration. In the last few years, six countries in the heart of continental Europe—France, West Germany, Italy and the three Benelux nations—have achieved an unprecedented level of economic integration under the Common Market. And this process of economic integration may go much further.

These sound like the opening lines of a success story. So it is in many ways, but out of this progress have come new problems. The steps the Inner Six have taken to draw together in the European Economic Community have inevitably created a new division between them and the other countries of Europe. The widely accepted and apparently clear-cut policy toward European integration the United States has followed in the past no longer provides clear answers to the key questions we face.

Less than three years ago, on March 2, 1957, the Six signed the Treaty of Rome that set up the European Economic Community, popularly known as the Common Market. It aims at a common tariff on imports from outside the group and no internal trade barriers.

Though the world was impressed by the willingness of the Six to undertake these great commitments, it had a right to be skeptical as to whether performance would equal promise. Anything could happen in the 12 to 15 years allowed to put the new measures into effect. Agricultural products were excluded from the general rules. The compromises that had been written into the treaty—many of them concessions to France, where inflationary pressures and protectionist sentiments were strong—raised doubts as to whether liberal trading policies would dominate the Community.

The course of events altered this

outlook and the pace of integration quickened. European businessmen began to act as if the Common Market were just around the corner, not years off. They made investments, mergers, licensing and distribution arrangements to win positions in the enlarged market. The dominant note was one of expansion. Prosperity helped, giving promise that adjustments could be made in an expanding, not a contracting, economy. As a result, the pressures to retain protection were reduced.

A crucial change took place in France, which in the past oddly combined the roles of bellwether and stumbling block for European integration. The De Gaulle government made long-needed reforms which did much to weaken traditional French protectionism. De Gaulle's foreign policy was also generally favorable to the development of the Common Market, though possibly presaging a change in its political character.

In this atmosphere of optimism the governments of the Six agreed to speed up economic integration. Starting this year, they will reduce tariffs on trade within the Community faster than the treaty stipulates. They will also take the first steps toward the common external customs tariff a year ahead of schedule.

There is more to this than speeding up the removal of trade barriers. The Six are aiming at the creation of a true community which may someday be political as well as economic. They have been glad enough to sharpen the distinction between those inside the Community and those outside.

On the economic front, it seems likely that the Community will create its customs union at least as rapidly as the new schedule calls for. But, so far, economic integration in transport, finance, labor, agriculture

and other fields is not progressing rapidly.

The direction of the Community's political development is still uncertain. Its central organization, the European Economic Commission, plays a crucial role and is not directly controlled by the governments. But intergovernmental cooperation is the dominant force in the Community's activities. President De Gaulle's recent pronouncements show that this is likely to continue. "More or less extranational" European organs, he declared, "have their technical value" but they cannot cope with major issues. Such issues, the French President said, must be dealt with by the national states, "the only entities that have the right to order and the authority to act."

This view is not incompatible with increased economic integration. But it does foreshadow a rather different Europe from that depicted by those who wish to delegate increasing power to supranational bodies. It emphasizes, too, the extent to which the future of the Community depends on the relations among the nations within and without it—especially France, Germany and Britain.

Inevitably, as the Six drew closer together, a rift opened between them and the rest of Europe. Their near neighbors have naturally been concerned about the effect of the European Community on their exports, which go in large part to the Six.

A British proposal designed to meet this problem won strong support among the smaller countries. The British plan called for a free trade area made up of the countries belonging to the Organization for European Economic Cooperation. (The OEEC includes all the non-Communist European countries except Finland.) In this free trade area, all internal tariffs and quotas would eventually have been eliminated. Each country, however, would have been free to set its own tariffs and quotas on imports from the rest of the world.

But the British proposal could not be reconciled to the Common Market structure. Contributing to this failure was the feeling that outsiders were trying to get much more than they were willing to give.

Even more fundamental, however, were two difficulties. One was deep suspicion on the Continent that Britain's real intention was to prevent the consolidation of the Six. The other was the fact that any comprehensive arrangement with Britain was bound to upset the careful balance of political and economic compromises on which the Treaty of Rome rested. Many felt this threatened the whole Community, and it was particularly unacceptable to France.

After this rebuff by the Six, Britain took defensive action. With the



Scandinavian countries, Switzerland, Austria and Portugal, Britain formed the European Free Trade Association. The seven nations agreed on a free trade area for industrial products and made special arrangements about some agricultural trade. While this step promised some economic advantages and some compensation for exclusion from the Common Market, it was mainly intended to improve the bargaining position of the Seven. The new group, however, did not make any major new approaches toward the Six.

The Community's European Economic Commission took a rather relaxed view of the creation of the Seven. It ruled out serious consideration of any comprehensive arrangements on free trade area lines. However, it said that it would be glad to discuss with outside countries any matters they thought damaging to their trade. Under the most-favored-nation rule, such concessions would apply to all members of GATT (the General Agreement on Tariffs and Trade, adhered to by most free world countries including

the United States). This move by the Six avoided the creation of a European preferential trading area.

Tariff concessions

When the Six decided to accelerate the setting up of their customs union, a new note appeared in their relations with the Seven. Tariffs on trade among the Six were to be lowered to the disadvantage of imports from outside. These steps toward the common tariff meant that a number of national import duties, especially in Germany, would be raised. The blow was softened somewhat by the announcement that, with several exceptions, these moves would be toward a common tariff 20 per cent below that previously announced. Moreover, the Six said that the 20 per cent reduction might be made permanent if other countries reciprocated with tariff concessions of their own.

Not everyone in the Community favored these steps. Especially in Germany and the Netherlands there were those who preferred a larger trading area and feared that acceleration would reduce the chances for agreement with the Seven. Among the Seven the reaction was sharp, and the political tinge to the trade split deepened.

The United States was drawn into the dispute and initiated a series of conferences that did not stop the acceleration. What was happening was a sharpening of focus. Jean Monnet once said that the way to get the British to act was to succeed in what you were doing. Having miscalculated the solidarity of the Community during the free trade area negotiations, the British are now working out some of the consequences of that lesson.

This re-examination of the British position is probably the most important of the new events in Europe. Increasing public discussion in Britain makes it clear that concessions which were unthinkable a few years ago appear quite reasonable now. Today, a fairly impressive body of opinion favors full British membership in the Community. The British government can hardly go that far, but the indications are strong that it will make a new and much more comprehensive offer. At

their recent meeting, Macmillan and Adenauer must have talked about more than trade.

Even if a British offer to the Six were made, results are not certain. There are those in the Community who greatly prefer to have Britain outside it. But a serious British offer would also strengthen the hand of those within the Community who seek to close the gap in Europe. There will be hard bargaining on all sides. Whatever the outcome, there will be new problems—for the United States as well as for Europe.

Everyone knows that the United States favors Western European integration. But now we face the questions: What integration? What Europe?

Ten years ago the United States played a central role in European integration. Our motives were political and economic; our most active policies were those directed to the removal of barriers to trade and payments among the Western European countries. The United States, however, took a much smaller part in the formation of the European Coal and Steel Community. After the defeat of the European Defense Community, Washington virtually withdrew from active diplomacy fostering integration. The United States had very little to do with setting up the Six and the Seven.

U.S. initiative

As the Common Market took shape, many people in this country felt that the American role had become too passive, and there was concern about the Common Market's effect on our trade. Washington prepared for tariff negotiations. It was the deterioration of relations between the Six and the Seven, however, that brought the United States into action again. Under Secretary Dillon's trip to Europe in the fall of 1959 had several purposes. His primary objective, however, appears to have been to reduce the political dangers of the split between the Six and the Seven.

He took the initiative in organizing several committees and conferences where genuine complaints could be examined, and dangerous and exaggerated talk quieted. Both the Six and the Seven restated their

basic positions, but there was no active American intervention to work out new trading relations. Furthermore, the United States endorsed the proposals for acceleration of the Common Market before the Six governments had adopted them.

Underdeveloped nations

The question is: Why did we adopt this policy? The reasons are not hard to understand. First, Washington puts a high value on the political achievements of the Community, especially in linking France and Germany. There is fear that pressure to broaden the Community would weaken it politically.

Second, the United States is more sensitive than previously about tariff discrimination against its exports. The change in the balance of payments position of the United States has made it important for us to foster our exports. While no one expects to undo the discrimination inherent in the Common Market, the United States is entitled to look very hard at proposals that would extend the area of preference.

Finally, there is an increasing emphasis in American policy on meeting more effectively than before the economic needs of the underdeveloped countries of Latin America and Japan. The European Economic Commission's proposal to make its future tariff concessions on a most-favored-nation basis responds very well to the U. S. concern with its own trade and the needs of the underdeveloped countries.

These are all strong points; but there is also much to be said against some of the judgments they entail. The question, however, that we face is what our future policy should be.

It would be presumptuous to try to prescribe in a few paragraphs a policy for the United States in the complex circumstances of the new stage of European integration. Four fundamental elements, however, should be taken into account. These are: the requirements of our trade; the political effects in Western Europe of economic arrangements; the limitations of our power; and the impact of European integration on the rest of the world.

First, we must look after our trade interest. The effect of the Common

Market or of a larger free trade area on American trade is very difficult to estimate. Obviously, producers inside the Common Market have an advantage over Americans outside the tariff wall. The common tariff of the Six will increase the duty on some American exports. The general American attitude has been to accept these commercial disadvantages for two main reasons. They seem not too great a price to pay for the political advantages brought by the closer union of the Six. And the dynamic effect of the Common Market may in the end more than offset initial disadvantages by increasing the demand for American goods. Whether similar arguments apply in the case is debatable.

Be that as it may, the U. S. has a strong interest in the reduction of the external tariff of the Community—or of a member country of the European Free Trade Association—to the lowest possible level.

Protecting U.S. interests

So far, the Six have shown a willingness to adopt a liberal trading policy. (The next test will be their agricultural policy, which is of great importance for American exports.) The Six have even recognized the difficulty the United States may have in reducing duties in the GATT negotiations at the beginning of next year. They have said that the United States—and the underdeveloped countries—need not reciprocate fully right away to obtain the 20 per cent reduction in the common tariff that

they are offering. But, in the long run, the United States can only improve the entry of its goods into the Common Market by admitting increased imports of European goods to the United States.

An agreement between the Six and the Seven to exchange preferences or form a customs union would increase the area of discrimination against American goods. German machinery sold in the United Kingdom would pay no tariff, but American machinery would. British chemicals would have the same advantage over American chemicals in the German market.

The new agreement might be a full customs union or free trade area. It might consist of special arrangements between the two trading blocs. In that case, it would require especially close scrutiny. Special deals are apt to be made at the expense of outsiders. In general, the more comprehensive the arrangement, the better.

Plainly, if the United States is to support a new trading arrangement between the Six and the Seven, it must be satisfied that it stands to gain something—politically or economically.

A second fundamental of American policy is to avoid a serious split among our allies in Western Europe. Economically, a division into trade blocs might be tolerable. That would depend on its effects on the countries of Europe and on the level of tariffs among them. But from the political point of view, there is a danger that



an economic division will become something worse. Baron Snoy, a former Belgian official with long experience in European economic affairs, recently expressed such a fear. In *Lloyds Bank Review* he warned that trading blocs might lead to "an inevitable element of opposition and rivalry, economic interests tending to crystallize in the imagination of men around two distinct structures within free Europe. From that, it is only one further step to think of a permanent opposition of interests on the political plane as well. . ."

A minimum requirement of American policy is to prevent that kind of deterioration. This does not mean that we have to accept the view that every "political" complaint justifies special trade treatment. Nor does it mean that the United States must always be "neutral" in Europe. By supporting the Six on acceleration we may have promoted unity. But it would be stupid to allow our support for Continental integration to force Britain into political or economic isolation. The idea of the United States "choosing" between our British and our Continental allies is repugnant. The most elementary rule of policy is to prevent such a situation from arising. The British re-examination and the Adenauer-Macmillan talks may mark a movement away from this danger.

Limited influence

A third fundamental is the need to recognize the limits of our power. No one supposes that the United States can impose an arrangement on Europe. We can sometimes prevent something from being done, and we can often influence what is done, but lasting arrangements among the European countries can only be created by them. Miriam Camps, one of the closest American observers of these matters, argues in the October *Foreign Affairs* that we can have an important influence on the kind of relationship that the Six and the Seven work out. But, she emphasizes, this depends, in the first place, on our accepting the need for new relationships between the Six and the Seven. If we deny this, "we may well find ourselves in a position to have little say about the terms in which it is made."

Our influence can also be great inside the Community itself where there is a constant tug of war between those favoring a more liberal policy and those preferring the benefits of exclusiveness. What we do or promise will have a great effect on this struggle, especially with regard to the Six's external tariff. But here, too, our continuing influence depends on our ability to carry through

THE INNER SIX

Members — France, Italy, West Germany, Benelux countries.

Tariff cuts—(a) internal: 20% since 1959; 10% on January 1, 1961; all to be eliminated by January 1, 1970; (b) common external tariff by January 1, 1970.

THE OUTER SEVEN

Members — Austria, Denmark, Great Britain, Norway, Portugal, Sweden, Switzerland.

Tariff cuts—internal: 20% since July 1, 1960; all to be eliminated by January 1, 1970.

on specific suggestions and offers. In trading matters, at least, this is synonymous with making our foreign trade policy more effective.

The fourth fundamental is that our policy toward European integration has to be part of a broader policy. It cannot be a Europe-only policy. Western Europe, like the United States, is concerned with the economic and political health of the entire free world. Internal trade difficulties dissipate Europe's strength. But the region needs to mobilize its new economic power. Of course, Europe's trade problems cannot be solved by pointing to loftier issues. The solution, however, must not make it harder for countries outside Europe to prosper. Africa, Latin America, Japan, India, Canada and others have an important stake in Europe's trade policies.

We too are outsiders as far as European trading arrangements are concerned. It is no betrayal of our friendship for Europe or our support for integration to act with other outsiders to keep discrimination against our trade to a minimum.

GATT can be the focus for this policy. It is the one forum where regional trading arrangements can

be effectively tested against their impact on the rest of the world. It is to Europe's long-run interest that GATT standards should be strengthened, not weakened, for Europe will be the outsider in future regional trading arrangements.

Politics and economics

Like the United States, the Six, the Seven and most other countries stand to gain from a system of multi-lateral trade. There is a case for regionalism but the burden of proof rests on those who would depart from the broader principles. The strengthening of GATT is the best means we have of meeting this crucial problem.

At the moment, new moves are likely to originate in Europe, probably in London. A fresh approach from Britain will almost certainly elicit a fresh response from the Six. The United States will surely want to support measures promising political understanding. We have good reason to prefer a Europe in which Britain, France, Germany and the others are working together to one in which a Continental bloc stands alone. But the United States can question whether better political understanding requires the creation of a preferential trading area in Western Europe (whether it is called a customs union or something else).

If we are persuaded that this is necessary, this country should use its influence to minimize the unfavorable impact on ourselves and other outsiders as well as to maximize liberalization of trade inside Europe. If a durable, comprehensive arrangement promising liberal trading relations with the rest of the world proves too ambitious, the opposite course should be explored—but gingerly. This course would aim to keep to a minimum the preferential trading relations inside Europe. It would permit only those absolutely necessary to reach an agreement and to relieve the most serious economic burdens. This course is dangerous, for it tends to weaken rules and undermine principles. But, with proper safeguards, it might be worth the risk, if it would remove otherwise intractable obstacles.

If the United States decides that exclusive regional trading arrange-

ments in Europe are unnecessary, it should not let itself become the opponent of the Seven, and particularly Britain. Instead, it should work with the Seven, through GATT, to exert the maximum influence on the external tariff of the European Economic Community and on its economic policies generally. This is not to be hostile to the Six; it is to support their highest purposes.

Either of these policies means that the United States will have to play an active, if unpublicized, part in European discussions. We must try to avoid an agreement between the Six and the Seven that would be undesirable to the United States. We would be hard put to it to defeat a united Europe on such an issue.

All of these policies require pressure for the lowest possible external

trade barriers in Europe. To attain our ends we need bargaining power. On political issues we have a good bit. In economic affairs there are a number of weapons, but by far the most important is the ability to engage in effective trade bargaining. In this we are, at the moment, very weak. It will take a strong initiative in the White House to overcome the obvious political obstacles. ■

Realities in Search of a Theory—No. 2

When Is a Market a Market?

by SHAW LIVERMORE

■ WE LIKE TO VIEW our economy through a mirror of polished theory. Unfortunately, there are distortions in that mirror; it tends to reflect what is accepted and approved at that particular moment in the fashionable Bond Street world of economic theorists. Consequently, while the economic body in actuality may be a little ragged and unkempt, through the mirror of theory it is apt to appear resplendent.

We nurture carefully another mistaken view of our economic system. That notion is that our beloved free-market, free-enterprise system is new and distinctive—the “only one in the world’s history.” We dislike intensely to be told that history has been the weaver of the warp and we have merely added some bright colors in the woof. But no doubt the merchant guildsmen of the 12th and 13th centuries were equally boastful of their bright new “free-enterprise” system of that day. So were the merchants of Venice, and perhaps even the Phoenician traders.

The organization of economic enterprise into the parallel systems of guilds rested on basic emotional attitudes and grooved patterns of mind which persist today. The craft guildsmen fixed prices—through guild rule, borough regulations or royal decrees—and competed instead in quality and product differentiation. (Our guild-derived word “masterpiece” expresses this kind of competition.) Twentieth-century American businessmen also seek, conscious-

Second of a series of articles dealing with the lag between the way we think our economy behaves and the way it actually does behave.

ly or subconsciously, to fix prices—through legislation, trade association pressures on mavericks, price umbrellas, tariffs and quotas.

Many observers have also been struck in recent years by the parallel between the personnel policies of the great feudal baronies and our modern American industrial corporations. Both have cared for their own liegemen through life, provided them with the capital and prestige of the corporate body and retained their allegiance by fringe benefits and perquisites.

Nor were there lacking, especially in England, counterpressures similar to those we have today—pressures for freedom to invade markets and pressures against the cozy restraints of guilds, boroughs and feudal entities. The famous medieval fairs were valiant attempts to introduce price flexibility, new products and shopping district competition.

Serious obstacles

But foreign innovative traders had to be blessed and guarded by the sovereign. Later efforts toward greater freedom of enterprise also ran up against serious obstacles.

Our sense of history must thus engender honest surprise that the surge of free enterprise could have gone so far in our United States during the

19th and 20th centuries. This surge has had an immense effect on the Western world. In this we can take honest and proper pride. But our sense of history should also prevent our being surprised that men should seek ways to limit, evade or soften the often cruel effects of “perfect” competition.

During the past 30 years economists have been busy shifting their analysis of the market in order to provide a mirror which more accurately reflects today’s reality. But theoretical economists are still far from sure just what the true state of competition is in our society—to what extent it is imperfect (ruled by product differentiation rather than price competition), to what degree it is oligopolistic (dominated by a few sellers in major segments of the total market), or to what extent true monopoly exists.

This uncertainty accounts for the active wrangling that goes on over statistics which supposedly show how a few sellers dominate pricing and supply in subsegments of the market. There is also disagreement, bred of uncertainty, as to the actual strategy and tactics of the oligopolists who are *really* (or are they?) the dominant factor in price making, innovative substitutions and supply schedules. The economic model builders, equation solvers and game-strategy theorists are always slightly upset when an investigator quizzes real-life business decision makers in terms of their actual strategy and tactics.

Nevertheless, the past three decades have shown some remarkable changes in economic thought. It is now accepted that the imperfect markets of today may lead to "better" social results than would a perfect system of market competition. This is a great change in attitude since the first quarter of this century. At that time the suggestion that markets not reflecting the purest of pure competition could have some "good" social results would have been contemptuously rejected by most orthodox theorists.

The preoccupation of economists with market phenomena has followed quite closely our national preoccupation with the production and consumption of physical commodities. More than the layman sometimes realizes, the current doctrinal teaching of economics reflects our national objective of material prosperity. This is most depressingly evident in analysis of how the system achieves growth.

"Growth" is defined in very narrow and materialistic terms. Direct price competition, with sensitive adjustments in price according to changing supply and demand conditions, is now understated as a characteristic of our markets. More emphasis is given to competition based on product differentiation and brand-name loyalty. This kind of competition gives intangible strength to established producers and, consequently, creates a barrier—over and above the barrier of capital requirements—to the free entry of new producers into the market.

This whole philosophy of the market is obviously reminiscent of the medieval guild structure on a larger

scale. Just as in the guilds, there is a constant ebb and flow of competitive seeking for the consumer's favor within a stable price structure. Thus, producers' shares of the market tend to fluctuate not so much because of price but because of the effectiveness of various "attachment strategies" directed toward consumers.

Aside from creating a barrier to the free entry of new producers into a market, this present market situation invalidates, to a certain extent, the old and dearly held doctrine that suppliers must attempt to maximize profits in the short run—that is, they must behave in the simple, classical manner of the selfish economic man whenever there is an opportunity.

This is necessary behavior under a system of perfectly free price competition in which the market is continually changing and prices on specific items may fall at any time. Profits must be maximized in the short run lest in the long run there be none. But where there is no price competition, where the producer must establish a "product image" in the mind of the consumer, profits must be calculated on the basis of the long run, and the old theory no longer applies.

The efforts of the theorists to design a grand and inclusive theory of the market must take into account such changes in the market situation. The theorists may even have to stop trying to create a single explanatory theory which covers the whole range of market transactions. We must seek a better understanding of the great segments of the total market where strategies of commodity marketing become irrelevant.

National defense objectives and

government subsidies in support of various social and cultural programs, for instance, are two large areas of our national economic activity which need to be studied. Economists should be as concerned with behavior in these great portions of our markets as they are with the acrobatics of oligopolists.

Special market mechanisms simply do not go far enough in explaining how our economy works. Public school education, for example, cannot be purchased by family consumers at retail in weekly tickets which pupils deposit on the teacher's desk for each week's attendance. How would public education fare if this were possible—if "education tickets" could be bought in various price classes, or for three-day weeks, or for cheap or fancy grades of education?

Double-stamp specials

Even more spectacularly, how would the military defense of the country fare if each free buyer were allowed to "buy" in the neighborhood supermarket his week's supply of military defense, with double-stamp specials on the B-70 one week and on nuclear-powered submarines the next week?

Descriptive analysis and "motivation research" is needed to show how the nation arrives at "market decisions" on the portion of national income it decides to spend on military defense. What forces are brought to bear on public opinion? Would anything like the same result be achieved in a truly free market where the sum of consumer decisions supposedly creates the final balance?

How were the decisions to create our National Park system or our great reclamation and conservation projects arrived at in past decades? How have some of our great cultural and technical projects been organized, financed and supported? How did we as a nation originally decide, in the course of the 19th century, to establish a free public and compulsory school system? Would such projects ever have come to be through the workings of the open market? Or would beer and skittles have won out by big margins?

Certainly such an analysis would indicate that the "votes of consumers" in open markets do *not* make



all our great decisions. And another of our cherished economic dogmas would begin to appear slightly tattered and outworn.

Such an analysis would bring out another curious anomaly in our tribal beliefs. We boast that our free-enterprise system gives the consumer a plush-carpet access to comparative value judgments. Through advertising—via the mass media of TV, newspapers and magazines—and through the advanced techniques of mass merchandising, the consumer has ample opportunity to compare the merits of a vast quantity of items.

Free market personified

The American system of merchandising certainly carries on this process far more skillfully than any other technique the world has hitherto known. The purchasing agent in America personifies the free market; he is the fully informed buyer, nimbly shifting his position on the theorists' demand curves and turning them into realities.

But, in the interests of consumer welfare, why should not this merchandising process be extended over the entire spectrum of market choices which the public faces? Shouldn't the Lighthouse Service, the Food and Drug Administration or the Corps of Engineers (with budgets carefully related to their total "sales") be allowed to conduct billboard educational campaigns on the virtues of their service to society? Shouldn't they be permitted to argue in public on why they need "profits" as a basis for constant expansion? This is obviously impossible now, since one of the oddities of our society is the almost universal prohibition on advertising by any public agency or body. What is good is bad!

A study of the relationship between buyers and sellers in today's market place reveals other lags in conventional economic theory. First, consumers do not, in many instances, purchase a discrete product or service, though it is popularly supposed that this is exactly what they do purchase. What they actually buy is a mixture of immediate use, financing assistance, taxes, availability of repair service, future replacement parts, installation expense, and intangibles such as reputation of the maker and potential resale value.

Second, there are a whole range of behavioral forces at work which affect the market process. Imitativeness, inherited parental standards, role-playing and status symbols have all become increasingly important in determining individual and family expenditures. These "side factors," which economic writing tends to ignore, have acquired a marked influence even in business spending.

Third, the value to consumers of publicly or socially provided services (usually paid for by taxation) has never been properly explored by orthodox economic theory.

Nor do the legal concepts of anti-trust always relate to the reality of our complex structure of varied markets. The courts in the past two or three decades have dealt with only a very few areas of our complex market structure, and then in terms which lag seriously behind the realities of interindustry and interproduct competition.

Finally, the degree to which consumers—especially buyers within industry itself—have become far better equipped to measure comparative values has not as yet been appraised. The mixed methods by which consumers acquire knowledge of new products and reach buying decisions need integrated analysis by social scientists.

It may well be that the over-all role of advertising is far more constructive in some areas than economists have ever been willing to concede—and far less important in other areas which the advertising fraternity itself takes most pride in. Critiques of advertising and its socio-economic role have been "black versus white"—a curious lag behind reality in both directions.

The Institutionalists, an almost forgotten group of "political economists" of the late 19th and early 20th centuries, were, indeed, preoccupied with a broadened approach to economic analysis. They showed how historical and social forces, the bias of inherited institutions and the legal framework affect the market in the largest sense.

Unfortunately, this approach to economic thought has become *passé*. The mathematicians of today are busy explaining theoretically the results of market forces and presenting

them as though we were living in a historical or social vacuum!

But if we are to reach a realistic understanding of our economic life and its future, we must certainly look beyond the mathematical models and fascinating game strategy of oligopolists. We need to ask such questions as these: Toward what ends is man striving in his economic effort? How do political bias and restrictions affect the way the economic drive is permitted to operate? How do the social climate of our society and our inherited drives and restraints affect us? For true self-understanding we need an approach similar to that of the 19th-century political economists—men now neglected in a world of frustrated mathematicians turned economists.

If 20th-century economics cannot or will not widen its terrain to cover *political* economy, a good case can be made for "inviting in" other social science practitioners. The complex attitudes of consumers, both with respect to physical goods and intangible and cultural satisfactions; the interplay among personal, group and national objectives; the amalgam of inherited prejudices, institutional arrangements and value-judgments—all belong in a truly probing analysis of economic markets.

Phenomena of market action

There are many signs that consumers' wants will increasingly shift toward the intangible and noncommodity area in coming decades. These are precisely the areas where the prevailing mechanistic economic analysis is least useful.

Many students of the American scene have suggested that the phenomena of market action in our complex society ought to be studied as a spectrum. It seems obvious to them that there is no single brand of market theory which will explain the whole range of these phenomena. There are only the varied shadings of an intricate pattern, from the infrared of open auction markets to the ultraviolet of hidden monopoly power on an international basis.

These observers tend to be impatient with theorists who construct models and draw demand curves on the assumption that manufactured commodities or processed materials alone are important in the

total market place. They are equally impatient with those who feel that all markets should be simple free markets and that all political or social welfare decisions are distortions.

Patently unrealistic

The attitudes thus decried are patently unrealistic to any serious student of American social history. Our political and other group decision-making processes are as American as is our gadget-marketing.

The highly complex socioeconomic mechanism which we have painstakingly (and democratically) constructed since 1890 cannot be carelessly indicted. Such an indictment would amount to as great an insult to an honored national past as would the consignment of the Founding Fathers of 1787 to the ash heap of history. The past 70 years of our history are as deserving of respect as are the first 30.

Under this approach, we would no longer make nostalgic efforts to describe all markets in terms of some wished-for norm, treating variations as aberrations or unwelcome exceptions. The "markets" for public education, for irrigation and water conservation projects, for assistance to friendly allies, for cultural activity and for recreation areas would all be examined as valid expressions of social objectives and social wants.

No longer would theorists be bound by the curious attitude that there is something suspect and un-American about consumer expenditures not devoted exclusively to the commodities produced by private firms. Perhaps the public would learn to accept the idea that "the highest standard of living in the world's history" is built on more than private spending in the open market.

The area of manufactured or processed commodities would still, of course, be studied within one gigantic waveband of the whole market spectrum. But no longer would a disproportionate share of attention be devoted to this area of the spectrum by analytical economists.

The most significant characteristic of this major segment of the total market has received the least attention by economic analysts. This is the built-in inducement in an im-

perfectly competitive market to innovate. As I indicated before, according to orthodox theory, barriers to free entry into a market are created by the obstructive power of entrenched firms with differentiated products and consumer loyalties. These barriers, added to the high capital requirements of plant construction, have been the subject of great critical concern among economic theorists.

But a realistic survey of what has actually been happening in our complex business structure would indicate that at least some of this concern has been misplaced. Instead of meeting product competition head-on by direct duplication of the product, scores of large companies in the past 15 years have engaged in what may

be termed "side-slipping" competition—that is, they have entered a field by developing variant products and new methods of manufacture.

Between the development of a product and its ultimate marketing. Not only is our market structure today built to welcome new products and variations of existing products, but it is also geared to accept new production techniques as a strong factor in the constant improvement of our material welfare. Existent machinery, methods and products are normally viewed as obsolescent simply as a matter of the philosophy of American producers. The rapidity with which capital stock is replaced is another plus factor in the pace of our economic growth.

For these reasons, needed reappraisals of American market structure and behavior should take into account previously neglected strengths in our system as well as the broader spectrum of market activity. A really thorough and up-to-date theoretical treatment of market behavior in our system has yet to be made. Current economic analysis is at once too narrow in scope, and too shallow to probe our real strength as a nation. ■



be termed "side-slipping" competition—that is, they have entered a field by developing variant products and new methods of manufacture.

In pharmaceuticals, in household appliances, in automobiles, in office equipment and in dozens of other industries ranging from publishing to military equipment this innovation process has been taking place with increasing rapidity.

A key to the whole process is the high and steady profits of existent firms—profits which give them the additional capital needed to invade new markets in this way. In oligopolistic markets these profits tend to be stable and persistent. To the extent that these profits are being channeled into innovation, they are devoted to quite different social ends than simple economic theory has always described.

In fact, oligopolistic concerns have become the prime wellsprings of our progress in the restricted but still important "material welfare" waveband of the market spectrum.

Consumers have become far more

Gold and the Dollar Crisis*

A commentary by HENRY G. AUBREY

■ AFTER WORLD WAR II the U.S. dollar became the hardest, most coveted currency in the world; indeed dollars were so scarce that economists were talking about a permanent dollar shortage. But this sort of discussion ceased with unexpected suddenness. In fact, some observers, who only a few years ago believed that the rest of the world could not muster enough dollars to pay for all needed American goods, now fear that the United States may "price itself out of the market."

What are the facts behind this dramatic reversal of professional opinion? This question cannot be discussed adequately unless we first view the postwar trends in broad perspective. For the place of the dollar in the world economy cannot be altogether divorced from the comprehensive issue of the position of the U.S. in world affairs.

The actual developments are not in doubt, even though the interpretation of them may be. The U.S. emerged from World War II with its productive capacity undamaged and even vastly increased by its role as the West's armory, quartermaster and supplier of necessities and amenities.

Meanwhile, both victors and vanquished in Europe had suffered physical damage, economic disruption and a debilitating loss of momentum in recovery from the ravages of the Great Depression. Japan, the only sizable exporter of manufactures outside the industrial West, was similarly prostrate.

Consequently, only the U.S. had the productive capacity necessary to provide sufficient resources for current consumption, reconstruction and expansion for future growth. And when the Korean war introduced a new period of heavy arma-

ment expenditures to further strain the West's resources, the U.S. again had to provide the wherewithal.

In spite of generous American help, the European allies had badly depleted their foreign exchange reserves during World War II, and the effort of reconstruction was respon-

*Dr. Aubrey's abstract and commentary is based on portions of the book, *Gold and the Dollar Crisis*, by Robert Triffin, published by Yale University Press.

Abstracts of significant, original research are being prepared by leading scholars for publication in CHALLENGE at frequent intervals. These abstracts are presented as a public service in cooperation with the Joint Council on Economic Education.

sible for further attrition. Moreover, with their productive capacity insufficient for cumulative demands, the nations of the world could not export enough to pay for all the American goods they needed. These three factors—an uncommon need for imports, insufficient hard-currency exports and depleted exchange reserves—caused the "dollar shortage."

How was this dollar gap filled? American military expenditures abroad were a large factor; grants and loans, in addition to growing private investment, allowed allies and former foes to import far more than they could have afforded otherwise. Furthermore, this vast outpouring of dollars permitted a gradual rebuilding of depleted European reserves, partly in the form of gold, but largely through an accumulation of dollar holdings.

This development, though it was not recognized as such by most ob-

servers at the time, was the seed of the recent so-called "dollar crisis." These dollar holdings, like a depositor's rights to his balance in a bank, are tantamount to short-term claims on the United States. Held as actual bank balances (mostly time deposits), treasury bills, commercial acceptances, etc., they can theoretically be "cashed in" on short notice.

In other words, a foreign firm or individual can sell his dollars to his central bank; the central bank can, if it chooses, buy gold from the U.S. Treasury with those dollars, thus reducing the American gold stock accordingly. If this were done on a large scale, according to "dollar crisis" thinking, confidence in the dollar and its gold backing would be undermined. And the greater the foreign dollar holdings representing a potential claim on our gold, the greater the risk of an eventual flight from the dollar.

The problem is not that the U.S. is, or may be, in danger of running short of gold. In fact, gold had been accumulating in the U.S. in unprecedented amounts—in search of a haven during the 1930s and in payment for necessities thereafter. The high mark was reached in 1949 with nearly \$25 billion worth of gold—about 70 per cent of the world's gold reserves—concentrated in the U.S.

Then, after a period of relative stability (with gold reserves of about \$22 billion) the U.S. lost over \$3 billion during 1958 and 1959. In the same period foreign dollar holdings jumped from about \$13.5 billion to over \$16 billion. This abrupt deterioration—a loss of over \$3 billion worth of gold and an increase of about \$2.5 billion in liabilities—gave rise to the fear of a "dollar crisis" and to a great deal of soul-searching as to how long this country could endure such a drain.

The causes of this situation are well known. Recessions abroad affected our exports. Meanwhile, our imports continued to grow as, during our own recession, personal income was well sustained. Though many observers are still concerned about the competitiveness of American exports, U.S. trade has recently shown signs of a vigorous recovery.

But even among the optimists, few experts dare hope that the American

trade position will improve to the extent of wiping out our balance of payments deficit. For our foreign policy objectives commit us to vast expenditures abroad for military establishments and for economic assistance to less developed countries. This is the main reason why our payments exceed, and will continue to exceed, our receipts.

We cannot afford to look at our payments problem simply as a national issue. The U.S. is the world's largest trader and exporter of capital, both private and public. Furthermore, the dollar now ranks as a prime international currency in which much of the world's trade and finance is transacted; most foreign countries hold dollars as a reserve that rates with gold as a universal means of payment.

In fact, the dollar attained this prominent place only because central banks can convert dollars into gold upon demand. But the experts have begun to worry lest the U.S. cannot continue to meet such demands in the face of rising foreign dollar holdings.

It is helpful to recognize the paradox that faces the U.S. in world finance. By running a persistent balance of payments deficit, we have provided the rest of the world with dollars for current purchases and for larger reserves.

This reserve cushion permits other countries to weather fluctuations in their exports without the immediate need to clamp down on their imports—which, in turn, are someone else's exports—and thus start a downward spiral in world trade. If the U.S. were to succeed in eliminating its deficit, this source of liquid reserves would dry up.

In the meantime, world trade keeps rising, and reserve holdings ought to increase in some reasonable proportion. It is not possible to state

definitely what the ratio of reserves to world trade should be. For the world as a whole (outside the United States and the United Kingdom, which are the traditional reserve centers) the ratio of reserves to imports is not much less than before the Great Depression.

Varied positions

The position of individual countries, however, varies greatly, and some of them would prefer to have more reserves. And most of them would not want their reserves to drop below a certain level; if such a contingency threatened, they would take some defensive action, such as trying to reduce their imports. Then, in retaliation, others might do the same.

In such a manner insufficiency of reserves, or what is referred to in technical terms as "lack of liquidity," could reduce the volume of world trade. If such actions and reactions were spread widely enough, a deflationary spiral could be started. The depression of the 1930s offers an extreme example of this process.

Whatever the deficiency in the required growth of reserves, gold alone is not produced in sufficient quantity to fill more than a part of it. Under the present gold exchange standard the rest must come from generally acceptable currency holdings, a role that so far only British sterling and U.S. dollars have filled.

Sterling's contribution is no longer expanding and, in fact, the British currency has been repeatedly in need of support. If the supply of dollars were to be curtailed drastically, what would be the outlook for world liquidity? In this event, an improvement from the national point of view could aggravate a latent problem for the world.

This thought is so vexing because the danger of overreliance on a

single currency has once before led to trouble. In the interwar period, when sterling was the world's most outstanding reserve currency, its accumulation by other nations and subsequent conversion into gold marked the beginning of the end of the free exchange system. The world's monetary standard broke down and a wave of protectionist moves reduced world trade far more than even the low depression levels warranted.

To be sure, no one contends that the great depression was brought on by these monetary events; cause and effect in this instance are difficult to disentangle. In any case, we have been warned as to what can happen when a crisis of confidence constricts the use of national currencies as a payments medium.

"Money does not manage itself," said Walter Bagehot, the prominent 19th-century economist. International money needs a good deal of management indeed, and foresight is an essential part of management.

Today the dollar has replaced sterling as the mainstay of the international monetary system; in fact, this process has been so rapid that dollars supplied nearly half of the increase in the rest of the world's reserves from 1950 to 1957, while the contribution of sterling declined further from an already low level.

In the future, the British are likely to watch their reserve position too closely to permit a large accumulation of sterling in foreign hands. And it is well to recall that it is the willingness to let one's currency amass abroad (if only in the form of claims) that makes or breaks a reserve currency.

Gold, in turn, can hardly contribute more than about one-third of the world's reserve needs, assuming these needs were to grow as fast as world trade has increased in re-



cent years. Hence, the dollar may well become even more prominent as a component of national reserves.

But such a prominence also means growing exposure of the United States to sudden withdrawals of gold or short-term balances held by foreigners. The events of the last two years have given us a greater awareness of this latent peril. When the American payments deficit grew under the impact of the recession, the foreign financial community began to wonder about the outcome.

As easy money, designed to stimulate business activity, caused interest rates to fall in this country, capital was shifted to European markets where the return was higher; under the impact of rumors, speculative money moved in the same direction. The dollar outflow thus was further increased, and in some quarters the question was asked whether a continued outflow might lead to unilateral trade and/or payments restrictions, or a devaluation of the dollar, or both.

Such fears were clearly misplaced, or at the very least vastly premature, because the size of the American gold stock—nearly half the world's total—is still ample for any contingency.

Slowed, then accelerated

In the meantime, the outflow of gold has first greatly slowed; and has recently been accelerating again. But, as foreign dollar holdings grow, there remains a nagging doubt about the dangers of the next recession, or the one after that, or the next.

Some observers are not terribly worried about the danger of restrictions or devaluation (which, probably, can be prevented by the magnitude of the American reserves and our emergency access to the resources of the International Monetary Fund). They are rather more concerned with the domestic cost of defending the dollar's foreign position.

Could it happen in a future recession that we would not dare lower interest rates and ease the supply of money for fear of excessive capital outflows and the resulting loss of gold and dollars? In this event, would we have to buy external balance-of-payments stability at the expense of domestic prosperity? This is an alarming thought indeed, if

still a remote contingency at present.

And even this dilemma is only one side of a two-pronged issue. For by containing the outflow of dollars we would curtail the growth of the world's liquidity reserve. How, then, if gold production is inadequate, can sufficient international means of payments be secured to forestall the throttling of trade in the event of a future general recession?

Is the present system really rational if it compels the monetary authorities to steer such a narrow and perilous course between the Scylla of deflation and the Charybdis of monetary breakdown?

The danger, then, is that the growing reliance on the dollar as a key international reserve currency could eventually weaken the dollar's position by increasing its vulnerability to withdrawals of gold by foreign dollar holders.

Internally, there might be a danger that anticyclical policy may be hampered by the fear of excessive capital flows from the United States. Internationally, the system is in danger of becoming excessively dependent on the decision of a few key countries to increase, reduce, or continue the use of the dollar—or any other national currency—as their monetary anchor.

An ideal solution would do away with all these contingencies at once and abolish the use of national currencies as reserves altogether. In Robert Triffin's plan they would be replaced by an international "scrip" which would be interest-bearing, as are reserves now held in various government securities. Thus, such an international scrip would combine the safety of gold with the revenue derived from holding reserves in the form of interest-bearing securities. In effect, this would mean an internationalization of reserves.

Actually, a move toward greater international monetary cooperation was made after World War II. The International Monetary Fund (IMF) stemmed from a need for supplementary resources that could be drawn upon when national reserves were insufficient in emergency situations.

The British proposals for the IMF had gone beyond a mere cooperative buffer fund and suggested a truly in-

ternational institution akin to a central bank in the national framework, but this was not acceptable to the Americans at that time. Consequently, the present constitution of the IMF provides for drawing privileges in proportion to a country's contribution, with progressively more stringent conditions as the drawings mount.

The sufficiency of the IMF's resources to cope with widespread difficulties is a matter for argument. In the past at least, no one has had to be turned away for lack of funds and, to be safe, all quotas were increased by 50 per cent or more in 1959.

Further increases are conceivable, of course, but there is reason to doubt that the IMF would be capable of stemming the tide if both major reserve currencies, sterling and dollar, were ever in trouble at the same time. No palliatives could measure up to an emergency of such a magnitude. The ultimate solution, in Triffin's view, appears to be the removal of a system that permits any currency to be at the mercy of autonomous decisions by others.

Resources and safeguards

Moreover, even if the present system could be endowed with greater resources and better safeguards, the problem of world liquidity (the sufficiency of generally acceptable means of payments) would remain unsolved. If gold does not accrue fast enough and key currencies are progressively weakened, what is to take their place?

At the present time the creation of international deposit certificates, to serve both as international means of payment as well as national currency reserves, seems the only means of combining safety against depreciation losses with sufficiency of reserves on an international scale.

In brief, Triffin's prescription calls for each country to hold its reserves either in the form of gold or of international, gold-convertible deposits at the IMF.

In order to secure international reserves sufficient to support the expanding level of world trade, each country would be obliged to hold no less than an agreed minimum of its

total monetary reserves in the form of IMF deposits. Twenty per cent would perhaps be enough in the beginning; such a ratio would come close to maintaining the present level of contributions for most countries.

Interest, to be paid in line with the earnings of the Fund, would no doubt provide an incentive to hold more than the imposed minimum of national monetary reserves in international deposit money. Thus, no hardship would be caused by the establishment of a compulsory minimum.

This reserve system, in effect, would resemble the operations of a central bank and would permit the increase of "international money" through expanded lending operations. It was precisely this issue which caused the British plan for a broader IMF to founder after the war. The Triffin scheme suggests some safeguards to counter the inevitable objections. For unlimited power to increase lending and, consequently, the available means of international payments, might introduce a tendency toward inflation into the world economy.

Ideally, the total amount of "international money" created each year ought to coincide with the added need for world liquidity. But it is next to impossible to derive this percentage in an uncontroversial manner. Since the directors of this international institution are apt to be men well versed in monetary management, an appropriate system of voting procedures might be devised to avoid the inflationary danger.

Elusive wisdom

Whether even the most elaborate organization would also hold the key to the wisdom which seems to elude sometimes the most experienced managers on the national scene is, of course, another question. But, then, the present erratic system offers even less security to the expanding world economy than one of international monetary cooperation.

Undoubtedly, such a system would relieve the U.S. of the burdensome function of supplying the world with our own currency as the most acceptable means of international settlement next to gold. This would remove the persistent and increasing

danger that a large part of these dollar claims in foreign hands might some day bring about an unbearable drain on our gold reserves.

Moreover, should the United States ever be in need of support for the dollar, we could use the new Fund's resources. We would no longer have to hesitate to approach the IMF for fear of a loss of confidence in the soundness of the dollar. At the same time, our domestic policy would be freed of the pressures which the withdrawal, or the fear of withdrawal, of volatile funds may impose upon monetary management.

There is, of course, a price to pay in terms of diminished autonomy; for the internationalization of reserves inevitably means a sharing of management as well as responsibilities. Some frustration and a need to compromise are part and parcel of



multilateral decision-making. There is no denying, either, that a reduction of sovereignty is involved in such a scheme.

Since the war, a number of steps have already been taken toward broader international organization. Nonetheless, politically it was an uphill fight every time and certainly the need for further monetary internationalization must be well understood if such a move is to succeed.

This is true not only in the United States. In England no official action looking toward international reserves is in sight. Germany, with reserves exceeding those of the entire sterling area, has not shown interest in more international monetary management; neither has Italy, where gold and dollars have accumulated at an unprecedented rate in recent years.

In any event, nothing could be done against the wishes of the United States and nothing will be done unless this country is in the forefront of reform; the American weight in

world finance is too great to permit any illusions on this score. Therefore, American policy decisions are of paramount importance for the rest of the world.

There are indications of a broadened participation in international finance by the United States. New institutions have been formed with American leadership for financing world economic development. The Development Assistance Group, an informal forum of actual and potential capital exporters, is deliberating further measures. It is hoped that the proposed Organization for Economic Cooperation and Development will pave the way for better coordination of the foreign economic activities of the United States, Canada, and Western Europe.

Yet, while progress toward greater international cooperation is being made—really quite rapidly considering the traditional American hesitancy toward international commitments—there is a question as to how fast and how far the United States will move in the monetary field. This is not just a matter of sovereignty, or the fear of exposing the domestic economy to multilateral decision-making. It involves the new and still unaccustomed position of the U.S. in the world economy.

As the largest exporter of goods and of capital, this country has naturally assumed—rather than deliberately asserted—a place of prominence that is being reflected only gradually in the financial field, particularly in the private sphere. This process is far from complete, and it would not be easy, perhaps even hazardous, to anticipate the outcome. Rather, one might expect that a new and more comprehensive international structure in the monetary field will gradually evolve. This may well be in line with political processes—processes that rarely follow the outline of ideal solutions.

To be sure, there remains a possibility of serious crisis along the path; but, then, a clear and present danger rarely fails to evoke a strong, if sometimes belated, response. This, too, is perhaps part of the process of evolution toward a more rational international order. The Triffin proposal shows the solution; the path that leads to it has still to be charted. ■



The Rebels. Brian Crozier. 256 pp. Boston: Beacon Press. \$3.95.

- In this well-written and closely reasoned study, Crozier analyzes the major postwar rebellions. He examines why some, such as the one in Indo-China, succeeded, and others, such as those in Malaya, Kenya and Hungary, failed. The author, formerly an overseas correspondent and now on the staff of *The Economist*, has met a number of rebel leaders and knows Algeria, Vietnam, Indonesia, Malaya and Cyprus at first hand.

His conclusions are that "rebellions are a symptom of misgovernment," and in almost all cases they could have been avoided by changes in government policy. Faced with an armed revolt, a government can reply with repression without political concessions, as in Indo-China or Hungary, or with repression with concessions, as in Malaya or Cyprus.

Only when a government is prepared to go to any lengths can a policy of pure repression succeed, although it is doubtful that such a course will solve the problem permanently. At a time when one major rebellion is racking Algeria and others may break out elsewhere in the world, this book provides a useful guide to one of the most dangerous problems of today.

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The Public Years. Bernard M. Baruch. 431 pp. New York: Holt, Rinehart and Winston. \$6.00.

- This is the second volume in the autobiography of a distinguished American. It provides an interesting account of the author's role in government as an advisor to Presidents and an international trouble shooter during two world wars, a major depression and the present cold war. It also provides illuminating glimpses into the lives of Presidents and Prime Ministers, farm leaders and business tycoons.

The outstanding portion of the book describes the troubled years of World War I and the disillusioning peace that followed. From Baruch's story of the overwhelming crises faced by President Wilson during this time, there emerges a fine and sympathetic portrait of one of the great men of our century.

Also of particular interest to readers today is Baruch's view on disarmament

and the work of the U.N. Atomic Energy Commission. Appointed by Truman in 1946 as U. S. representative on the Commission, Baruch insisted from the beginning that a treaty on disarmament would only be an empty set of promises unless provision were made for an effective means of inspection and control. "Peace does not follow disarmament," says Baruch. "Disarmament follows peace."

Bernard Baruch has certainly led a long, useful and fascinating life. It is understandable that, in looking back over his years of public service, he should feel an honest sense of pride in his achievements. The sensitive reader, however, may wish on occasion that this sense of pride were a little less apparent.

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It's Cheaper to Die: Doctors, Drugs and the A.M.A. William Michelfelder. 192 pp. New York: George Braziller, Inc. \$3.50.

- Despite its sensational title, this book has some provocative—and rather frightening—things to say about the economics and ethics of American medicine. While the author concedes that his indictment of doctors, drug companies and most health insurance plans does not apply to everyone, it is impossible to judge how widespread are the unethical practices he describes. It is particularly difficult to judge the doctors. The Kefauver Committee has placed the drug companies under the glare of public scrutiny, and health insurance plans must justify their rates to state authorities. But the doctors police themselves through the American Medical Association. The root of the problem is not really the ethics of individual doctors—which are no worse (and probably considerably better) than those prevailing in other professions. The real problem revolves around the power of the A.M.A. and other professional associations whose members render a service which is essential to the public welfare. Rising medical costs are a serious problem to many middle-income families who do not wish to accept charity. The medical profession's contention (probably true) that people who can't afford

to pay are taken care of anyway does not answer the problem. In fact, there are many doctors who will not admit that there is one. Although it offers no real solutions and some of its facts are probably exaggerated, this volume will convince most readers that a real problem exists.

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The Squeeze: Cities Without Space. Edward Higbee. 348 pp. New York: William Morrow and Co. \$5.95.

- Is there any hope that we can solve our national problem of burgeoning metropolises with inadequate housing, schools, playgrounds and transportation? Higbee believes that the problem can be solved, or at least eased, but he doubts that local governments are willing to make the hard decisions necessary to implement a program of "preventative engineering." The blame, however, cannot be solely placed at the door of local governments. Federal efforts in the field of urban renewal and transportation have certainly failed to come to grips with the problem in its entirety. In emphasizing Washington's piecemeal approach, Higbee cites the federal highway program. This 15-year, \$27-billion program is administered through the states; there is no master blueprint of over-all objectives. From the point of view of space utilization, the railroads are still the best means of transporting commuters to our large cities. In other words, if our national and local governments had any over-all plan for saving our cities from strangulation, they would be subsidizing railroads rather than building more highways.

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The Politics of Upheaval. Arthur M. Schlesinger, Jr. 749 pp. Boston: Houghton Mifflin Co. \$6.95.

- This is the third—and best—volume in Schlesinger's brilliant history of the New Deal. It takes Schlesinger 657 anecdote-packed pages to cover the two years in the Roosevelt Administration from November, 1934 to November, 1936. But these were important years, and Schlesinger skillfully conveys the drama and excitement of the times.

While the author is scrupulously fair in his handling of the facts, his sympathies are obviously with FDR. Within the New Deal itself, he seems to prefer the "cooperative" (or "cartel-like") planning of the early New Deal over the trust-busting philosophy of Justice Brandeis' followers which characterized the later New Deal years. Readers who disagree with him on these issues, will not be satisfied with Schlesinger's interpretations. But even they should enjoy disagreeing with such a literate and interesting author.



Economic Affairs

A Monthly Analysis

A special supplement to CHALLENGE

November 1, 1960

STILL SIDESTEPPING ALONG, our economy is maintaining a stable level of output. The Federal Reserve's Index of Industrial Production stood at 109 for August, off one point from the previous month's figure. Steel production is still low, at 52% of capacity. Steelmen were disappointed with September, are hoping that the October figures will show an improvement. Much to everyone's surprise, private home building perked up. August housing starts were 8% over July's, but still well below the comparable period of last year.

Good and bad news can be read in the economic statistics. These days, a lot of people are reading bad news in them—and that's news itself. Business psychology is an important factor in the business cycle. Pessimism can reinforce a downward trend; optimism can mitigate it. Here are some of the things being heard about the economy:

Treasury Secretary Anderson holds that we're now in a readjustment, will soon emerge into another period of prosperity. On the other hand, an important Chase Manhattan Bank executive has predicted a recession, to start late this year or early next, and run into mid-1961. The sharp decline in stock prices during September indicates many doubts on Wall Street. Even consumers are becoming concerned about the state of the economy, according to a University of Michigan survey.

Fiscal action by the government is coming into play. No data are available as yet, but it's known that contracts for naval ships, aircraft and missiles are being stepped up. The Interior Department is speeding up some reclamation projects, hopes to be able to let contracts by early spring.

Monetary policy, however, is being hampered by the gold outflow. Our gold stock is down to \$18 billion, with \$19 billion of claims against it. Monetary authorities are hesitant about depressing interest rates further while such rates in foreign countries are high. The Federal Reserve's discount rate is 3%, the Bank of England's is 6%.

Countries whose economies are tied to ours are beginning to feel a little trouble. Gross national product in Canada fell 1.5% during the second quarter of 1960—a small drop, but the first in 3 years. In England, sales of consumer durables are weakening. But most of Western Europe is enjoying a great boom, checked only by a stringent shortage of skilled labor. European prosperity helps us, keeps our exports rising.

Our built-in stabilizers help us, too. When profits fall off, so do tax collections. If spending doesn't decline, this gives the economy a boost.

Government spending is slated to rise, not fall. And tax collections are falling as corporate profits go below expectations. Administration officials now predict a surplus of \$1.1 billion for the year ending July, 1961, instead of the planned surplus of \$4.2 billion. Actually, a deficit is possible. The next few months will show more clearly the direction in which we are heading. The strength—or weakness—of the fall upturn may be decisive.

SPECIAL CORRESPONDENCE—The debate over "it is a recession—it isn't a recession" is due to the fact that the indicators are unusually mixed. Industrial production has remained about the same throughout the year. Over-all personal income has held its own. But unemployment persists, as does less than capacity output in steel and other basic industries.

The fact is a recessionary mood prevails. The profit picture reflects this. So does a slumping stock market. No significant upturn is in the cards for another 8 to 12 months.

Other recessions were weathered without facing basic issues. This one, even though it is selective, may require some hard decisions. Dislocations of automation are becoming more apparent. The consumer will no longer pay the bill for higher industrial wages. Competition from abroad has become a decisive factor.

Interestingly enough, most of the issues in the serious General Electric strike, stated or unstated, revolve around these problems.

That dwindling budget surplus for fiscal 1961 is now estimated at \$1.1 billion. There is a good chance it will turn out to be a deficit as antirecession spending is quietly stepped up and business tax receipts slow down.

A new twist may be in the making for the Presidential election. The latest polls show 7% to 11% of the electorate still undecided. If an exciting issue does not emerge during the last weeks of the campaign, much of the "undecided" vote will not go to the polls.

There is a definite possibility that the total votes cast will be less than the 61 million turnout of 4 years ago. A light vote could favor Nixon, since a heavy turnout has traditionally meant dissatisfaction with the "ins."

Foreigners continue to express their confidence in the dollar by not claiming their gold reserves in this country. Such claims, if totally exercised, could wipe out our gold holdings. As it is, the U.S. still holds \$18.4 billion in gold, much more than the \$11.7 billion needed to back our currency.

The West German decision to underwrite a \$240-million program in aid of underdeveloped areas is considered inadequate by most Western powers. The hope is that this will be doubled after the 1961 elections, if Adenauer wins.

With credit being eased all along the line, look for a new boom in housing construction—which could start an inflationary spiral in 1961.

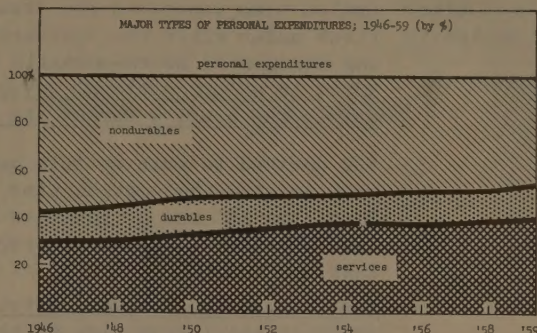
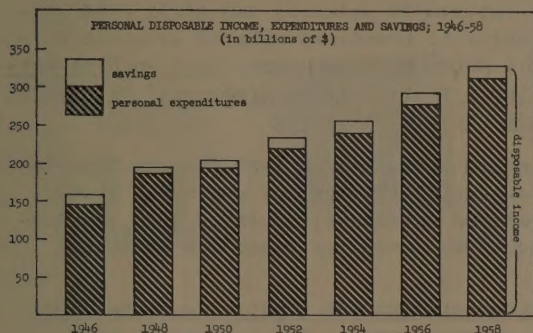
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THE DOMESTIC ECONOMY—Since 1946, the personal disposable (after tax) income of consumers has more than doubled—from \$159.2 billion to \$337.3 billion last year. Even if we take into account the 33% decline in the purchasing power of the dollar since 1946, this is a sizable increase in the consumer's buying and saving power.

How has the American consumer allocated this increased income? Prior to World War II, many economists believed that people's decisions to buy were determined by their income and that, as people's income went up, the proportion of income spent would decline. Savings, therefore, would proportionately increase as incomes went up.

As the graph on the opposite page (left) indicates, the consumer has not fulfilled the economists' expectations. While disposable incomes have gone up, the proportion of income spent has remained virtually unchanged. Thus, consumer expenditures came to 92.2% of disposable income in 1946; last year they came to 93%. In

fact, recent surveys on consumer finances by the University of Michigan indicate that postwar America is the only country in the world in which a relatively constant proportion of after-tax income is spent on consumer investment at all income levels. The American consumer is thus something of a freak in economic history.



How do we explain this? Obviously, the answer lies in part in what the consumer spends his income on. Contrary to general belief, the proportion of disposable income spent on durable goods (automobiles, washing machines, refrigerators, etc.) has not increased substantially. In 1946, 10.9% of consumer expenditures went into durables; last year the proportion was 13.6%. While nondurables (food, clothing, etc.) still take the biggest chunk (47%) out of consumer expenditures, their relative share has fallen from 58% in 1946.

The biggest increase, interestingly, has been in services. In 1946 consumer spending on services came to 31.1% of the total; last year that proportion had risen to 39.4%. The consumer is spending an increasing proportion of his resources for such things as medical care, transportation, education and insurance.

For the most part, these figures do not reflect a shift in buying habits so much as a shift in the relative cost of the things the consumer buys. The relative increase in consumer expenditures for services, for example, reflects increases in the cost of services and, only to a lesser extent, an increase in the quantity and quality of services purchased.

Thus, the 2 items in the Bureau of Labor Statistics' Consumer Price Index that have risen fastest are both service items—transportation and medical care. Since 1946 transportation costs have risen 50%, while medical costs have gone up 60%. Nondurable items such as food and clothing have risen much less rapidly.

In other words, the reason why Americans have continued to spend the same proportion of their rising income may be that they have become more conscious of such "social" services as health and education—just when a rising birth rate was forcing up costs in these areas.

The postwar years have seen one extremely important shift in consumer behavior: the increase in house ownership (see ECONOMIC AFFAIRS, Aug. 31, 1959). It is, therefore, interesting to note that a recent Federal Reserve Board Survey clearly shows that the demand for housing reflects income. Thus, more than half of the nonfarm families earning more than \$5,000 are homeowners and only 2/5 of the families earning less than \$4,000 own homes.

It, therefore, seems likely that even if the consumer continues to turn from the conspicuous consumption of durables to services and housing, he will continue to consume the same proportion of his rising income. That is what makes the American consumer unique.

FCC
upholds
"option
time"
contracts

ECONOMIC NEWS NOTES—The Federal Communications Commission, by a 4 to 3 vote, has granted television networks an important victory by upholding the continued use of "option time" contracts.

Option time contracts are those between TV networks and affiliated stations under which the stations agree to broadcast network programs during designated hours—usually the prime evening hours. This enables networks to assure national advertisers that their programs will be viewed across the country during the most desirable hours.

FCC decided to rule on this question because of a 1959 Justice Department opinion that option time contracts violated the antitrust laws. Since the FCC has no power to rule on antitrust issues as such, the Justice Department can still prosecute the networks under the antitrust laws.

The FCC ruling, however, gives the networks the right to continue the practice until such time as the courts render a final opinion; this could take years.

* * *

FPC adopts
new
formula

The Federal Power Commission has finally come up with a formula to implement the 1954 U.S. Supreme Court ruling in the Phillips Case placing producers of natural gas in interstate commerce under FPC regulation.

Under the new FPC formula, producers' prices will be set on an area basis rather than on the traditional utility concept of cost-plus-return used in the regulation of interstate gas pipelines.

The Commission is setting up prices for each major producing area based on costs and historic pricing patterns. It is not, however, attempting to determine the costs of each individual producer. If a producer feels that the area price is too low for him to operate profitably, he can appeal his case to the Commission.

Although the new regulatory formula is favored by most producers over the cost-plus-return concept, it will probably be challenged in the courts by gas consumer groups.

Since the Phillips decision 6 years ago, there have been several unsuccessful attempts to enact legislation exempting gas producers from federal regulation. The one bill that did get through Congress in 1956 was vetoed by President Eisenhower because he did not like the tactics of the lobbyists pushing the bill.

The chances for such legislation in the new Congress are problematical. Nixon favors it while Kennedy opposes it—disagreeing with his running mate, Lyndon Johnson, who has been a staunch supporter of bills exempting gas producers from regulation.

* * *

overseas
investment
drops

The increase in foreign investments by U.S. companies in the first half of 1960 was running at an annual rate of only \$2 billion compared with a rate of \$2.4 billion in the same period last year.

Practically the entire drop can be attributed to the sharp curtailment of overseas investment programs by U.S. oil companies because of the world-wide petroleum glut. The country hardest hit by the cutback was Venezuela, the beneficiary of heavy U.S. oil company investment during the past 5 years.